Europe Equity Market Outlook: Q3 2023

Grinding Through 2023.

Morningstar Equity Research

Michael Field, CFA
European Market Strategist

Ben Slupecki, CFA
Associate Equity Analyst

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Market Overview

Investor Confidence Takes a Dent in March, but the Market Rolls On

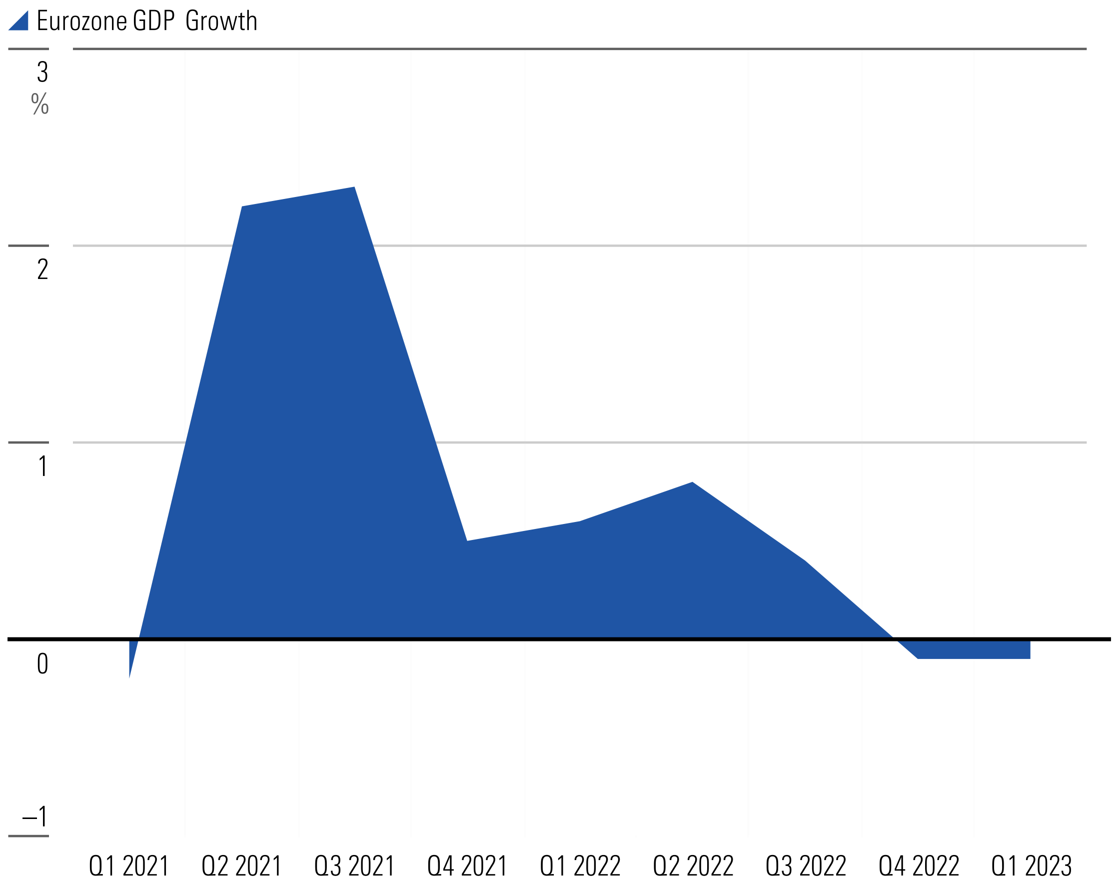
Recession Eventually Bites in Europe

The eurozone slipped into recession in the first quarter of the year and this shouldn't come as a shock to anyone. Growth has been teetering on the edge for some time now, with the Purchasing Managers' Index in the red for much of last year. What it adds though is another complication to the mix.

Currently, economists are predicting anemic growth north of just 1% for the eurozone over the full year. Inflation remains well above central banks' targets, at almost 8% in the U.K. and 5.5% in Europe. Interest rates have ramped up quickly and are now putting consumers and businesses under real pressure, with further possible increases to come this year.

So far this year, investors have been looking beyond the short-term situation, focusing on 9 months, or even 12 months, down the line when inflation and interest rates should be lower and gross domestic product growth began picking up again. The problem is the longer this situation takes to resolve, the more investors' mettle will be tested. A straight-line improvement in conditions would be nice, but any deviation could send investor confidence into a tailspin, bringing market volatility.

Revisions To GDP Growth Mean the Eurozone Is Officially in a Recession



Source: Eurostat. Data as of May 31, 2023.

Equity Market Valuations Climb the Wall of Worry

Market Cap-Weighted Price/Fair Value Estimate for Morningstar Europe-Domiciled Coverage

Source: Morningstar. Data as of June 22, 2023.

After a volatile couple of quarters, eurozone valuations are back to being almost fairly valued again. On a price/fair value estimate basis, the European market is trading just 2% below our intrinsic valuation

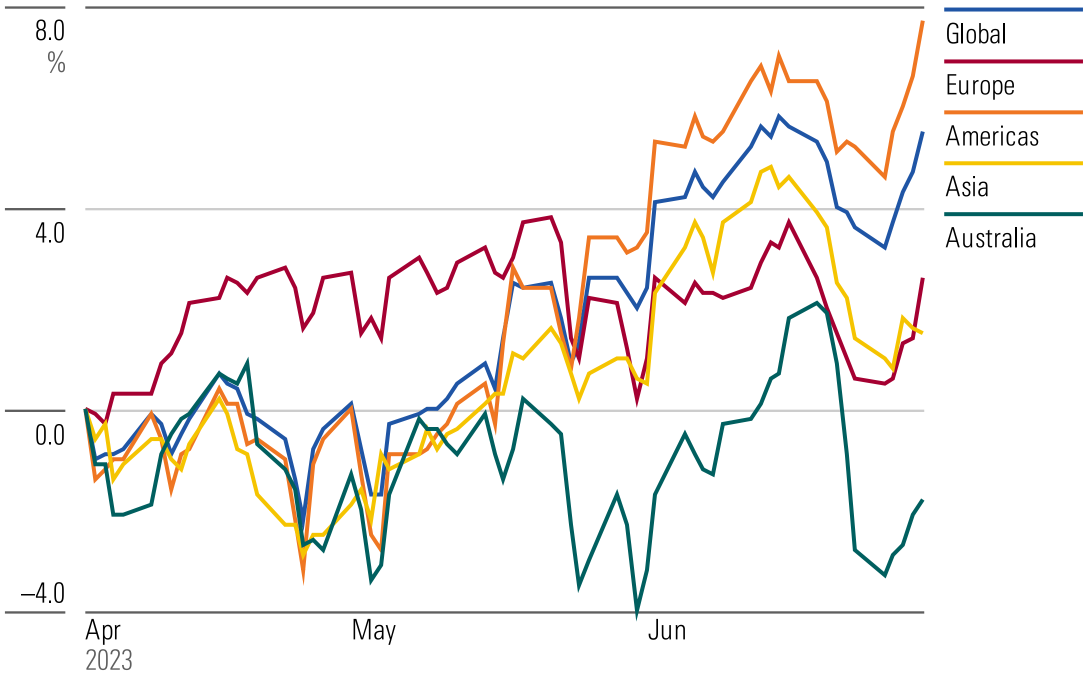
We are now a long way from the bargain territory of late 2022 when markets were trading at a 20%-plus discount to our fair value estimate, but equally we are a way off the heady days of two years ago when markets were trading at a material premium to our valuation.

Getting to this point is one thing, but for markets to move north from here it will likely take a boost in investor confidence that can only come from a material improvement in underlying market conditions over the coming quarters.

European Growth Slows After Two Strong Quarters

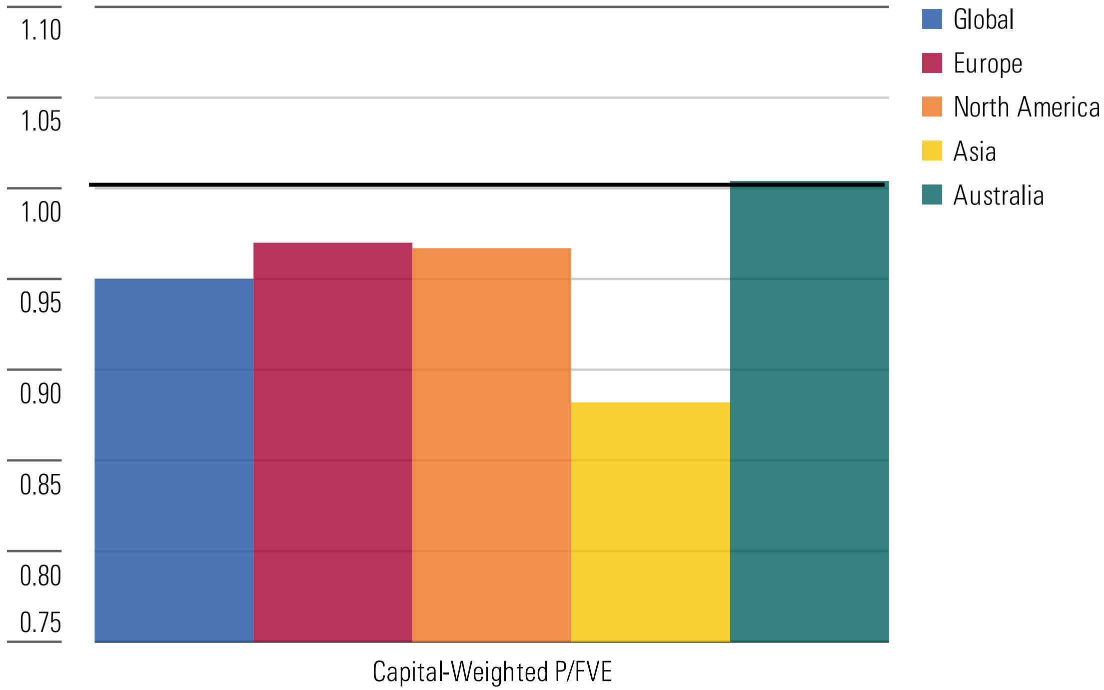
While the European market performance is still moving in the right direction, its turn as leader of the pack has come to an end this quarter, with Australia the only region performing worse over the period. However, after two strong quarters valuations in Europe are top of the heap, trading closer on par with our fair value estimate for the region.

Regional Price Movements Over the Second Quarter



Source: Morningstar. Data as of June 30, 2023

Capital-Weighted Price/Fair Value Estimate for the Regions



Source: Morningstar. Data as of June 15, 2023.

Value Remains Out of Favour and Growth Overvalued

The valuation of growth stocks rose over the quarter, bringing the entire segment further into overvalued territory. Value, on the other hand, fell further out of favour, possibly explained by the reality of a recession in Europe. The bias toward growth remains more pronounced in Europe than the U.S.

Investors in Europe Currently Favour Large-Cap Stocks With Growth and Core More Highly Valued*

Europe Intrinsic Value-Weighted Price/Fair Value Estimate

Size	All	Style: Value	Style: Core	Style: Growth
All	0.91	0.78	0.90	1.08
Large	0.93	0.79	0.92	1.11
Mid	0.82	0.75	0.86	0.87
Small	0.71	0.67	0.67	0.87

US Intrinsic Value-Weighted Price/Fair Value Estimate

Size	All	Style: Value	Style: Core	Style: Growth
All	0.97	0.86	1.00	1.01
Large	0.98	0.87	1.03	1.01
Mid	0.91	0.84	0.93	0.97
Small	0.74	0.58	0.84	0.92

Overvalued
- ≥ 1.10
- 1.05 to 1.10

Fairly Valued
- 1.01 to 1.05
- 0.99 to 1.01
- 0.95 to 0.99

Undervalued
- 0.90 to 0.95
- ≤0.90

Source: Morningstar. Data as of June 22, 2023. * May not be fully representative of investment styles due to limited coverage in certain segments.

Sector Valuation Overview

Opportunities Remain Despite Rising Valuations

European Equity Markets Continue To Tick Up

Gains this quarter were harder to come by, but markets still rose marginally over the period, bringing gains over the last 12 months to more than 6%. Considering that a banking crisis occurred during this period, this is not a terrible result.

Financials was the clear winner over the period, rising by 6,5%, followed by technology and consumer cyclicals, both up close to 5%. These sectors have compounded gains over the last 12 months, with consumer cyclicals the major winner, generating returns of more than 20%, driven by the "risk-on" investor attitude late last year and earlier this year.

Financials had sold off in March during the banking crisis, but reasonably solid earnings updates from the banking sector since that have gone some way to assuring investors that large-scale banking failures are unlikely for now. This has been enough to bolster share prices in the sector.

Last quarter we spoke about the potential for continued sector rotation as interest rates rise. With no let-up in interest rate hikes from the European Central Bank and Bank of England, this theme could certainly continue into the third and fourth quarters of the year, as the market adjusts to the new reality.

Aggregated Stock Price Changes

Sector	TTM% Change	Trailing Quarter % Change
Aggregated European Market	6.1%	2.5%
Cyclical		
Basic Materials	(7.7%)	(1.8%)
Consumer Cyclical	22.8%	4.7%
Financial Services	14.2%	6.5%
Sensitive		
Communication Services	(3.3%)	(5.0%)
Energy	9.0%	(0.6%)
Industrials	12.0%	3.4%
Technology	11.7%	4.5%
Defensive		
Consumer Defensive	(1.0%)	(0.5%)
Healthcare	0.3%	3.1%
Utilities	2.9%	3.9%

Source: Morningstar. Data as of June 15, 2023.

All Sectors Remain Undervalued

There were no huge changes in sector valuations over the second quarter. Defensive sectors remain very much in favour, with the consumer defensive and utilities sectors within 10% of our fair value estimates. Healthcare's valuation also rose modestly, but we still see an attractive upside from here.

We see the most opportunity in the cyclically exposed sectors such as consumer cyclicals, communications, and financial services. Investors are understandably concerned about investing in such sectors in the event of a prolonged downturn, but we believe the gap between current valuations and our fair value estimates provides a sufficient margin of safety to warrant a further look at these sectors.

One thing that hasn't changed this year is that every sector across our coverage list trades at a discount to its fair value estimate. A situation we certainly don't expect to last forever.

Morningstar European Coverage Average Price/Fair Value Estimate by Sector

Cyclical Sectors	Average Price/Fair Value	Sensitive Sectors	Average Price/Fair Value	Defensive Sectors	Average Price/Fair Value
Consumer Cyclical	0.77	Comm Svcs	0.81	Consumer Defensive	0.93
Financial Services	0.81	Energy	0.83	Healthcare	0.86
		Industrials	0.98	Utilities	0.92

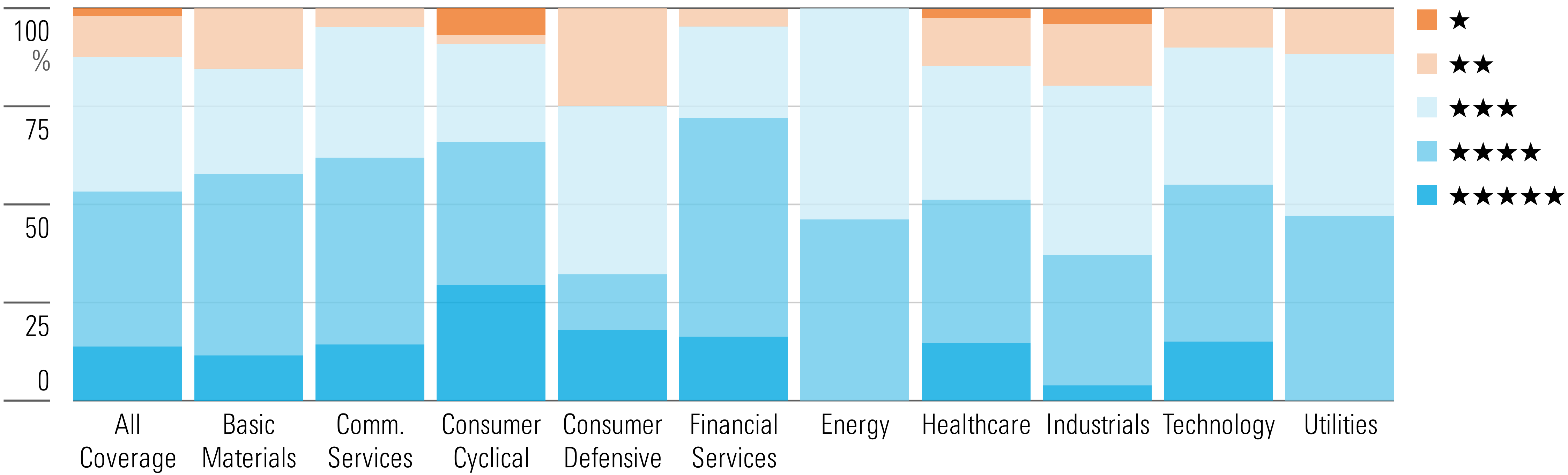
Source: Morningstar. Data as of June 22, 2023.

SECTOR VALUATION OVERVIEW

4-Star and 5-Star Opportunities Abound

Despite rising share prices and sector valuations, opportunities remain abundant at the stock level. In all but two sectors, 5-star stocks are present. Across our entire coverage less than 15% of stocks are rated as overvalued.

Star Rating Distribution by Sector



Source: Morningstar. Data as of June 22, 2023.

Communication Services

Javier Correonero | javier.correonero@morningstar.com

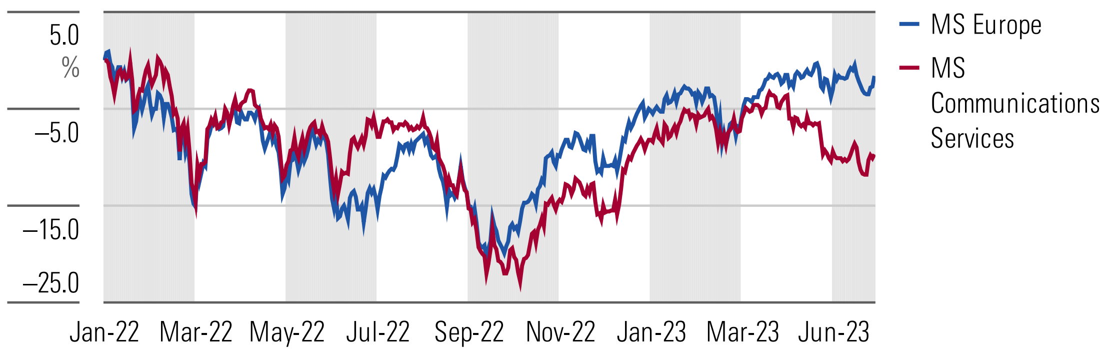
Underperformance Means More Opportunities, but Stock Selection Is Key

The Morningstar European Communications Index has underperformed the Morningstar European Index in 2023. At this point most stocks are in 4-star and 5-star territory, offering attractive upside relative to our fair value estimates. Although the European telecommunication sector is challenged as a whole, we believe the market has overpenalised some of these stocks. While several stocks have performed poorly year to date, other European telecommunication shares have shown resilience with flat or even positive shareholder returns.

Conglomerates such as Vodafone, Telefonica, and Liberty Global have seen their share prices underperform leaner companies with exposure to healthier markets such as KPN, Swisscom, and Deutsche Telekom. We believe the latter have benefited from higher cash flow visibility, lower exposure to emerging markets, and better ability to pass price increases to customers. Although names like KPN, Tele2, and Deutsche Telekom offer less upside potential, they remain our preferred names given their better management and capital allocation, exposure to healthy markets, and cost controls.

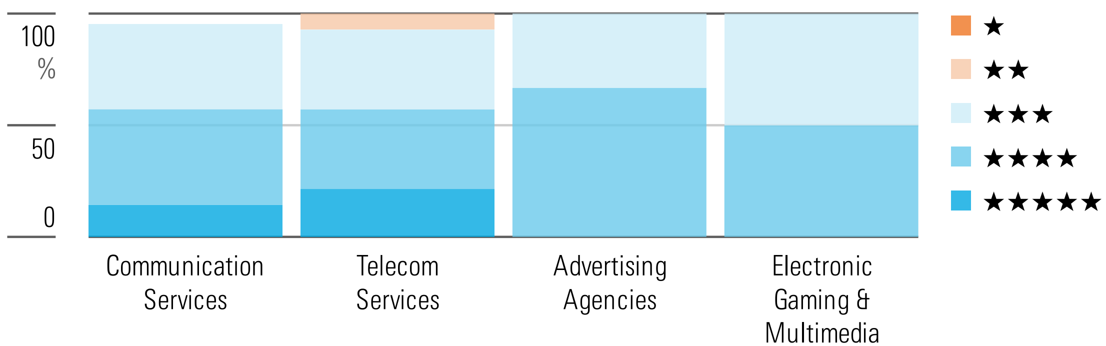
The European tower firms Cellnex and Inwit are also two of our top picks due to the attractive unit economics of wireless tower businesses.

Communication Services vs. the Morningstar European Index



Source: Morningstar. Data as of June 30, 2023

Communication Services Star Rating Distribution by Industry



Source: Morningstar. Data as of May 31, 2023.

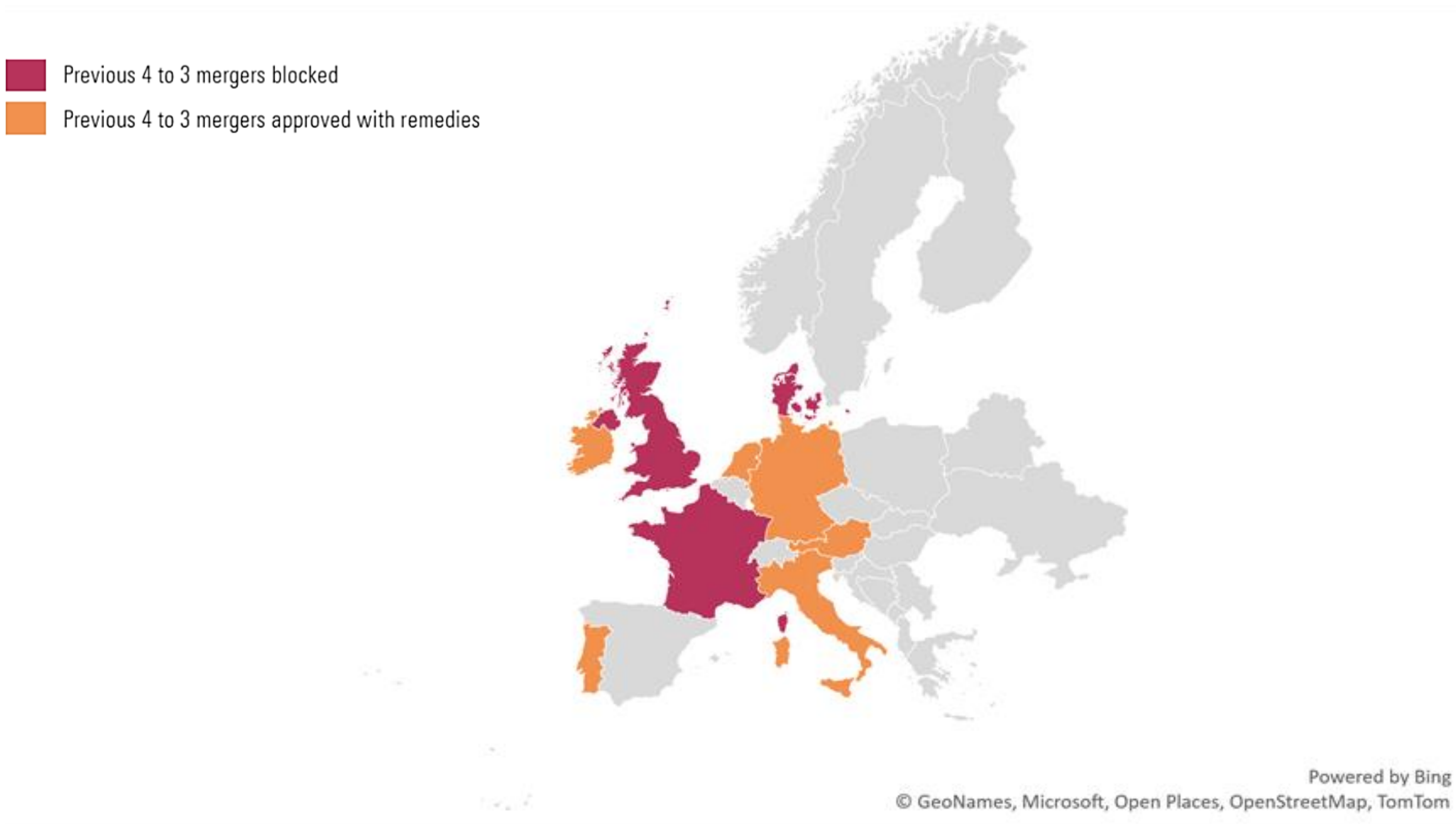
The Next Quarter Should Bring Important Competitive Implications for Telecom Firms

European telecommunication operators have been pushing for consolidation for more than a decade, but have seen their efforts jeopardized by regulators.

Orange and MasMovil are trying to merge their businesses in Spain, and Vodafone and CK Hutchison are trying to do the same in the U.K. Should both mergers be approved, they would reduce the number of mobile network operators from four to three in each country. Telecom companies claim the current market setup does not allow them to earn acceptable returns on invested capital to support their investments, an assessment we agree with.

Should one or both merger attempts be approved without amendments, it could be a game changer for future consolidation efforts. However, history is not in the companies' favour as many mergers have been blocked or approved with harsh remedies by competition authorities since 2010. A decision by the European Commission for the Orange-MasMovil merger is expected in September 2023, while the decision about the Vodafone-CK Hutchison merger attempt by the Competitions and Markets Authority will have to wait until 2024.

The European Commission Has Blocked Many Deals Since 2010 or Only Approved Them With Remedies



Source: Morningstar, European Commission, Company documents.

Communication Services | Top Picks

Name/Ticker		Rating	
Cellnex Telecom (CLNX)		★★★★	Cellnex owns and operates more than 100,000 wireless towers in Europe as a result of continued merger and acquisition activities since its IPO in 2015. Cellnex's business model is protected by long-term contracts, which provide high cash flow visibility, inflation protection, and growth optionality. Based on our unit economic calculations, we estimate Cellnex acquires towers at an internal rate of return in line with or slightly above its cost of capital, but we estimate returns will get closer to the 10% range as the acquired tower portfolios are made more efficient. Since late 2022, Cellnex's strategy has become more organic, with the aim of improving its tower portfolio and achieving a better credit rating.
Price	**Fair Value**	**Uncertainty**	
EUR 36.99	EUR 52.00	Medium	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
EUR 26.09	Narrow	Standard	

Name/Ticker		Rating	
Inwit (INW)		★★★	Inwit is the leading wireless tower operator in Italy, with Telecom Italia and Vodafone as its anchor tenant. Inwit has the highest tenancy ratio among European operators (close to 2.2 times) and leads EBITDA after leases (EBITDAaL) margins of more than 65%. We believe Inwit is a good company to navigate the current inflationary environment as its contracts are linked to the consumer price index with no cap and a 0% floor. In the next few years, we expect Inwit's EBITDAaL margins to expand above 70% due to new tenancy additions coupled with wireless towers' inherent operating leverage. We believe Inwit is a good play for investors looking for lower uncertainty with growing dividends (Inwit's 2024 dividend will increase by 40%).
Price	**Fair Value**	**Uncertainty**	
EUR 12.08	EUR 12.60	Low	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
EUR 11.59	Narrow	Standard	

Consumer Cyclical

Grant Slade, CFA | grant.slade@morningstar.com
Ioannis Pontikis, CFA | ioannis.pontikis@morningstar.com
Jelena Sokolova, CFA | jelena.sokolova@morningstar.com

Luxury Segment Slightly Overvalued; Opportunities in Apparel and Food Delivery

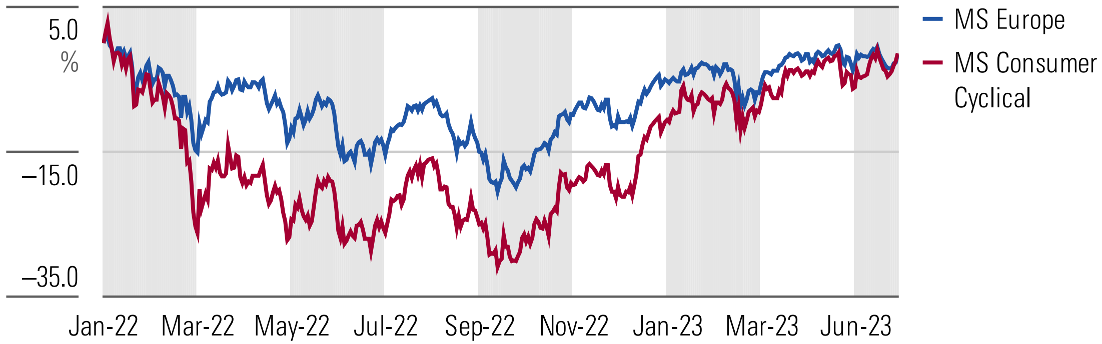
Morningstar Europe Consumer Cyclicals Index has experienced a sharp recovery so far in 2023. Moderating inflation and the removal of coronavirus-related restrictions in China helped boost consumer spending materially, leading to a more favourable outlook for consumer stocks.

The sector is largely attractively valued, with luxury goods now moderately overvalued, but internet retail companies' valuations remain alluring. Within the diverse internet retail segment of our coverage, we see pockets of opportunities in food delivery. Zalando and Pandora look particularly attractive in the apparel retail and jewellery segments, respectively.

Food delivery stocks are long-duration assets, meaning that a combination of increasing interest rates, the anticipation of a tighter capital markets environment, and elevated inflationary pressures, have all weighed on stock performance lately. Despite expected top-line growth slowdown as order growth decreases in the medium term we remain constructive, but investors need to be selective.

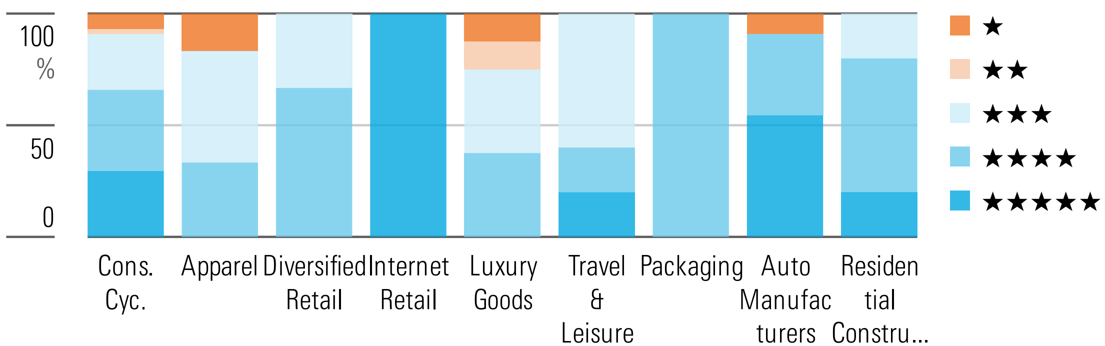
The U.K. homebuilders also screen attractively, with cyclical headwinds weighing on share prices industrywide. Profitability is under pressure in 2023 as the housing market declines cyclically in response to tightening financial conditions. While the near term appears challenging, the industry's long-term fundamentals remain bright. We think all U.K. volume homebuilders are well positioned to meaningfully contribute to the supply of new housing required by a growing and ageing U.K. population, delivering substantial expected shareholder value in the process.

Consumer Cyclical vs. the Morningstar European Index



Source: Morningstar. Data as of June 30, 2023.

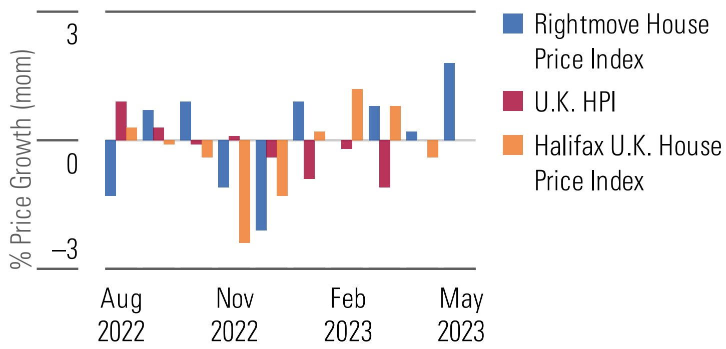
Consumer Cyclical Star Rating Distribution by Industry



Source: Morningstar. Data as of May 31, 2023.

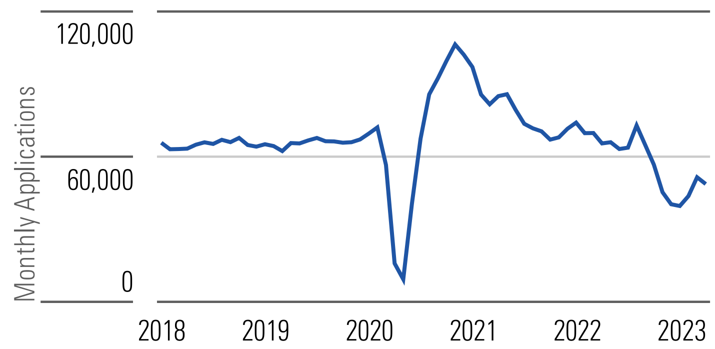
Investors Are Wrongly Focused on Near-Term U.K. Homebuilder Pain Rather Than Long-Term Gain

U.K. House Price Signals Remain Mixed So Far in 2023



Source: Office for National Statistics (U.K.), Rightmove, Halifax.

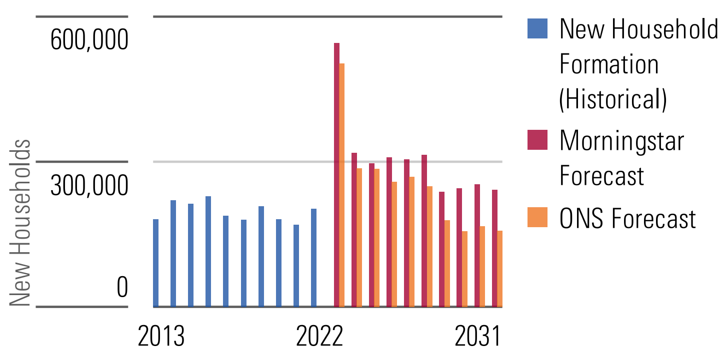
Mortgage Applications Rebound, but From a Low Base



Source: Bank of England.

Recently released U.K. housing data points are yet to provide investors with indications that the U.K. housing market has entered a cyclical recovery. Leading housing market indicators—including house price growth and mortgage application numbers—continue to provide mixed signals and have consequently done little to assuage investors' concerns over the ultimate duration and severity of the present housing market downturn. Consequently, U.K. homebuilders under our coverage trade at significantly depressed multiples of book value and steep discounts to our fair value estimates.

Housing Demand To Stay Robust As Population Ages



Source: Office for National Statistics (U.K.), Morningstar estimates.

Valuations Ignore Solid Long-Term Fundamentals

Our U.K. Homebuilder Coverage	Price-To-Book Value Ratio: Current	Price-To-Book Value Ratio: 5-year Average
Barratt Developments	0.97	1.44
Taylor Wimpey	0.86	1.45
Persimmon	1.16	2.32
Bellway	0.76	1.17
Berkeley Group	1.34	1.71

Source: PitchBook, Morningstar, Data as of June 15, 2023.

Still, current homebuilder share prices overlook their robust long-term fundamentals. We expect demand for new housing to remain robust over the coming decade, owing to a combination of continued population growth and ageing population—both of which create a need for new housing supply. We expect all the major homebuilders to meaningfully contribute to the supply of new housing in the U.K. over the coming decade. No-moat Persimmon is the top pick among our coverage of the industry.

Consumer Cyclical | Top Picks

Name/Ticker		Rating	
Persimmon (PSN)		★★★★★	Persimmon screens as materially undervalued despite near-term headwinds posed by the U.K.'s current waning housing cycle. Certainly, 2023 is shaping up as a challenging year for the U.K. homebuilding industry as earnings contract in response to falling home completion volumes, house price headwinds, and build-cost inflation, which remains elevated. Nonetheless, we think Persimmon's current share price fails to reflect its long-term fundamentals, which remain bright. We're attracted to Persimmon's differentiated focus on first-time homebuyers and the lower-priced segment of the U.K.'s housing market. Persimmon has demonstrated the capacity of its model to deliver handsomely for shareholders, having produced industry-leading profit margins and returns on invested capital over the preceding housing cycle of 2013 – 22.
Price	**Fair Value**	**Uncertainty**	
GBX 1,025.50	GBX 2,300	High	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
GBP 3.09	None	Standard	

Name/Ticker		Rating	
Just Eat Takeaway (TKWY)		★★★★★	Just East Takeaway is the best-positioned food-delivery player. According to our estimates, in Germany alone, where the company is a dominant player it is worth more than the current market cap, meaning investors get the rest of the business for free. The recent divestment of its iFood stake has removed refinancing concerns in the midterm while the Amazon/Grubhub partnership provides scope for profitable growth in the U.S. and a potential Amazon minority stake in future. Fresh 2023 guidance for adjusted EBITDA of EUR 275 million and positive free cash flow in mid-2024 reflect the group's profitable marketplace business and logistical efficiencies. The market appears sceptical about the sector's long-term growth potential, but Just Eat Takeaway's strong balance sheet and resilient marketplace business place the company in a strong position over the long term. From a valuation perspective, Just Eat Takeaway offers a rare investment opportunity in the food-delivery segment.
Price	**Fair Value**	**Uncertainty**	
EUR 14.04	EUR 81.00	Very High	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
EUR 3.09	Narrow	Exemplary	

Consumer Defensive

Ioannis Pontikis, CFA | ioannis.pontikis@morningstar.com
Philip Gorham, CFA, FRM | philip.gorham@morningstar.com

A Haven Amid Banking Turmoil and Inflationary Pressures

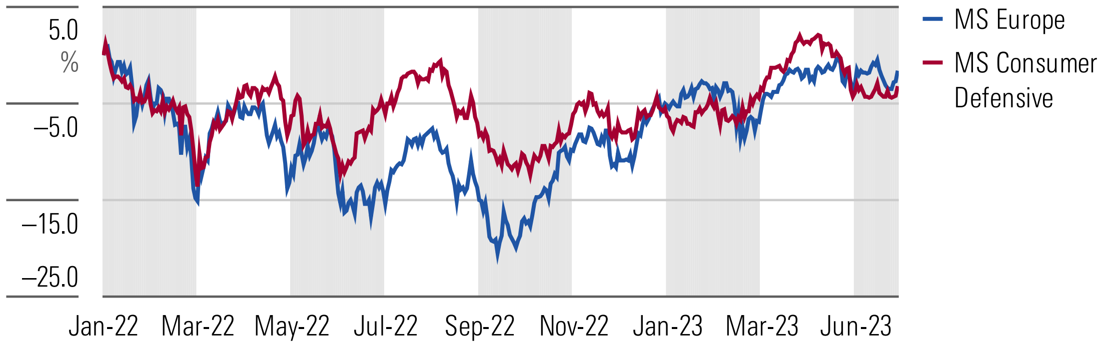
The Morningstar Consumer Defensive Index has slightly underperformed in 2023. A safe haven during the banking crisis earlier in the year, performance has since dipped as markets regain confidence. That said, the consumer defensive sector has historically proven attractive in the face of recessions, so could benefit from further sector rotation.

First-quarter earnings reports were strong with many Tier 1 companies beating our estimates on revenue (Nestle and Unilever). Although spot prices appear to have peaked, manufacturers are still pushing through unusually large levels of commodity cost inflation, while this is unlikely to ease until the second half of the year, we expect the intensity of pricing to gradually slow down.

The consumer defensive sector often outperforms in market downturns, but those cycles have usually been accompanied by falling interest rates. This time, although low-income consumers may struggle, middle-income consumers have reverted to prepandemic savings levels and despite the broad-based inflationary pressure, so far seem willing to accept higher prices. That said, many companies have commented on downtrading and intensifying competition from private labels especially in more discretionary consumer categories with weak brand power and high elasticities.

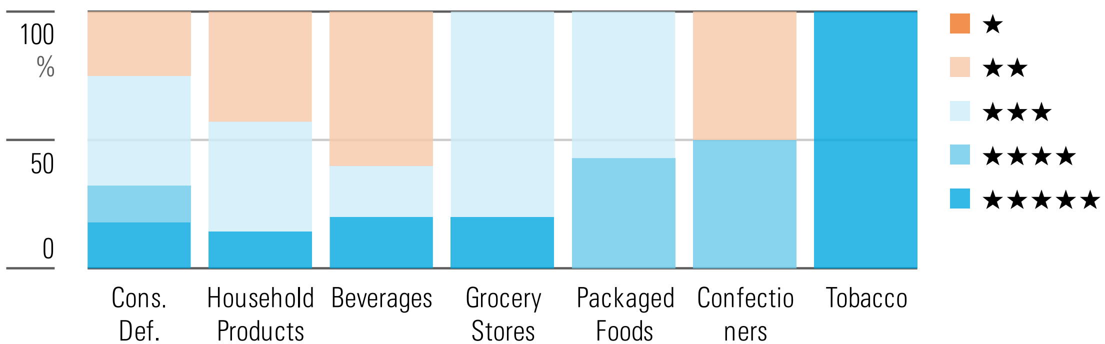
The sector now appears fairly valued although we see pockets of value among confectioners and beverage manufacturers. Despite a strong rally this year, some tobacco stocks remain undervalued.

Consumer Defensive vs. the Morningstar European Index



Source: Morningstar. Data as of June 30, 2023.

Consumer Defensive Star Rating Distribution by Industry



Source: Morningstar. Data as of May 31, 2023.

Inflation Is Challenging for Grocers, With Discounters Taking Market Share

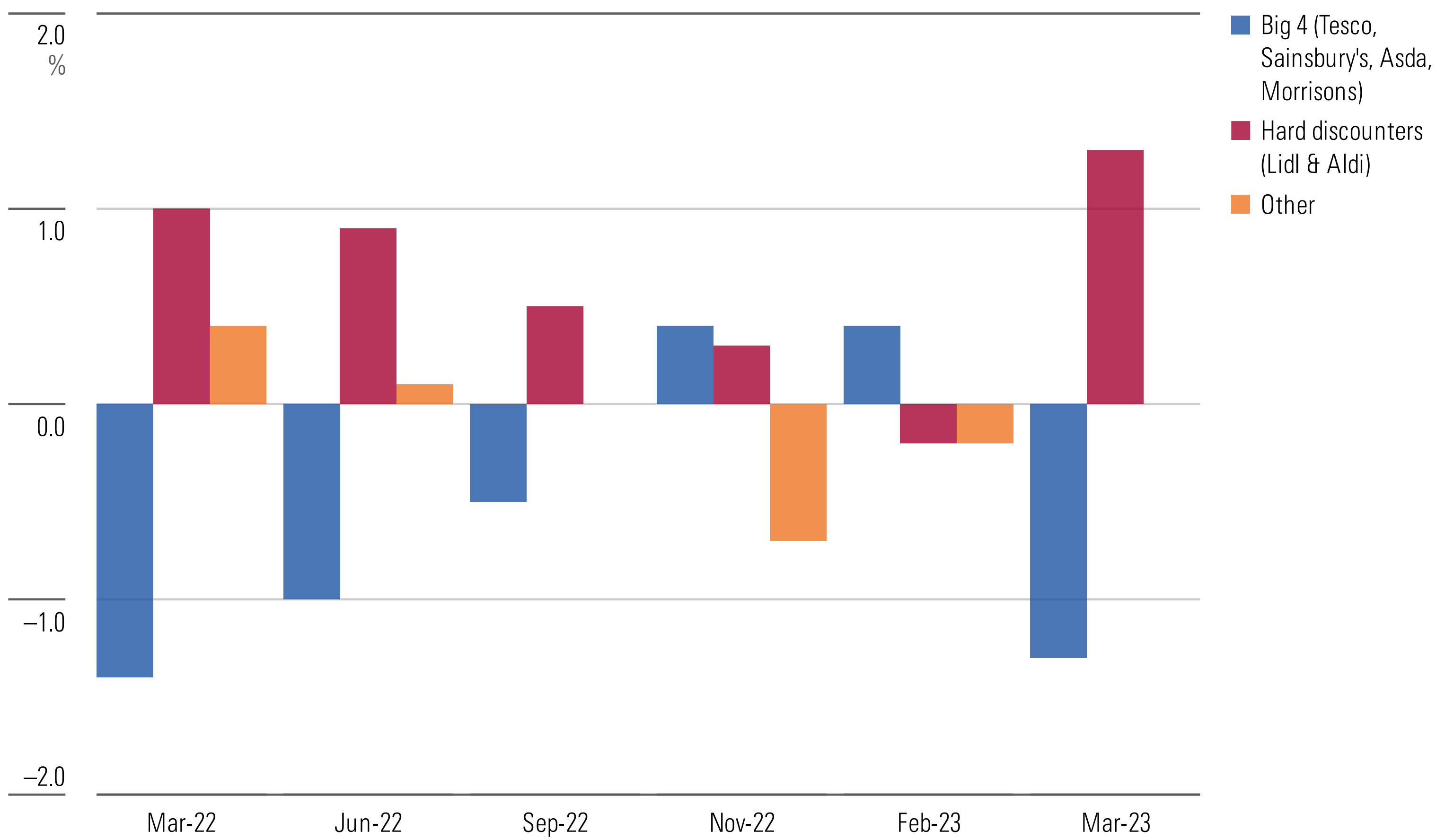
Higher inflation could spell trouble as consumers trade down, in which case traditional grocers without a strong market offering will find it difficult to compete with discounters. Recent share gains in the U.K. corroborate this. That said, a potential discounter-led price war would hit grocers on our list.

However, we don’t think this is likely as:

- at current price levels, discounters continue to gain market share;
- discounters’ profit margins are significantly lower than in the past; and
- grocers are much better positioned in the market-entry, value segment with significantly narrower price gaps versus discounters than in the past.

So far, recent market share development in the second quarter reflects the continuation of hard-discounters' share gains (from peaking in the first quarter) with Sainsbury's, Asda, and Morrisons being the biggest donors while Tesco is holding up better. Smaller retailers/grocers appear to be maintaining market share.

U.K. Grocery Market Share Developments



Source: Kantar U.K. data as of June 19, 2023.

Consumer Defensive | Top Picks

Name/Ticker		Rating	
Anheuser-Busch InBev (ABI)		★★★★★	AB InBev is a high-quality business with monopolistic positions in several emerging markets in Latin America and Africa. While the company has lost its share in developed markets, particularly craft beer in the U.S., AB InBev should benefit from premiumisation into its global brands in other markets, making the mix a strong growth driver. In our view, the stock is undervalued because of its high debt load. At the end of 2022, AB InBev reported net debt/EBITDA of 3.5 times, still much higher than the level of around 2.5 times that we think is maintainable in the long term. However, we expect leverage to fall to 2.3 times by the end of 2025. AB InBev reports in U.S. dollars, but generated less than one third of its EBIT in the U.S. in 2022. The strength of the U.S. dollar has weighed on earnings in the last few quarters, and reduced revenue by 3 percentage points in the first nine months of last year. The reversal in the dollar's strength would boost earnings growth.
Price EUR 51.83	Fair Value EUR 83.00	Uncertainty Medium	
Market Cap (B) EUR 102.82	Economic Moat Wide	Capital Allocation Exemplary	

Name/Ticker		Rating	
Barry Callebaut (BARN)		★★★★★	Barry Callebaut is well positioned in an inflationary environment due to its cost-plus pricing model (contractually passing on input cost inflation to clients, including freight cost inflation due to container scarcity) and is currently trading in 5-star territory, which presents an attractive opportunity for long-term investors. Given the slow start to the year and a still uncertain macroeconomic environment that forces manufacturers, especially in North America to prioritise destocking, management downgraded 2023 guidance on organic growth, which we believe has created opportunities for long-term investors. Midterm guidance of 4%-6% volume growth and 8%-10% EBIT growth is best-in-class and given strong execution should be rewarded with an above-average valuation multiple.
Price CHF 1,900.00	Fair Value CHF 2,330.00	Uncertainty Low	
Market Cap (B) CHF 9.47	Economic Moat Wide	Capital Allocation Standard	

Name/Ticker		Rating	
Tesco (TSCO)		★★★★	Despite the negative macroeconomic environment and cost-of-living crisis in the U.K. we think the outlook for Tesco is not as bad as the share price suggests. As long as grocery players act rationally and don't undercut their competitors, we believe the macroeconomic backdrop is a net positive for Tesco due to its scale and dominant offline (27% market share), online (37.5% market share), and food-service (largest-player) position in the core U.K. market. A discounter-led price war is the bear case for large U.K. supermarkets; however, we don't believe this is likely. We believe management's guidance on fiscal 2024 free cash flow is conservative. Apart from an attractive dividend yield, Tesco shares are attractively priced, trading in 4-star territory.
Price GBX 248.40	Fair Value GBX 298.00	Uncertainty Medium	
Market Cap (B) GBP 17.87	Economic Moat None	Capital Allocation Standard	

Energy

Allen Good, CFA | allen.good@morningstar.com

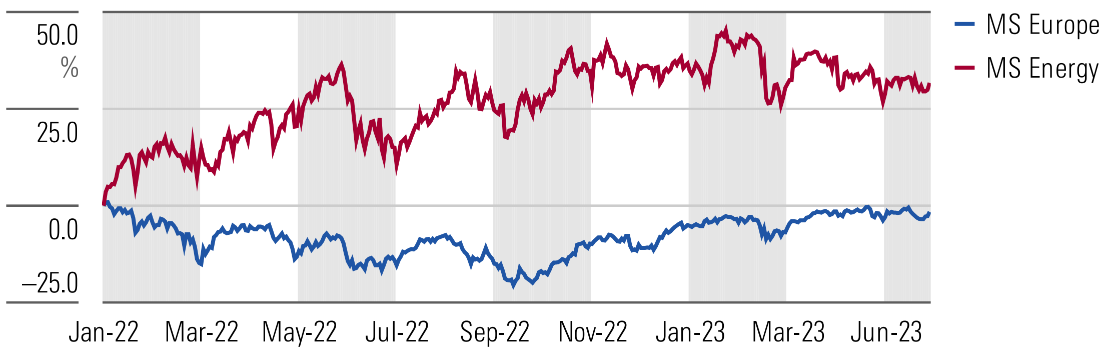
Integrated Oil Emissions Matter, Capital Allocation Matters More

At Shell's first capital markets day in two years, new CEO Wael Sawan and his team sent the right message—that returns would take priority over growth. Although, we believe the key actions accompanying the message—reduced spending and increased distributions—are positive and crucial steps, they are unlikely to be enough to close the valuation gap with U.S. peers. Furthermore, the long-term outlook remains uncertain with most guidance items only covering through 2025. However, we believe the new team has Shell heading in the right direction and places the company as one of the more compelling options among European integrated oils.

The tone set by Sawan and his team was likely the most important element of the update. We have previously argued that Shell and other European integrated oils' discount to U.S. peers Exxon and Chevron was a result of several factors, but differences in capital allocation and energy transition strategies were the most relevant and addressable. By stressing that all projects, most notably low-carbon power, must compete for capital and earn adequate returns, Sawan and his team sought to address this issue.

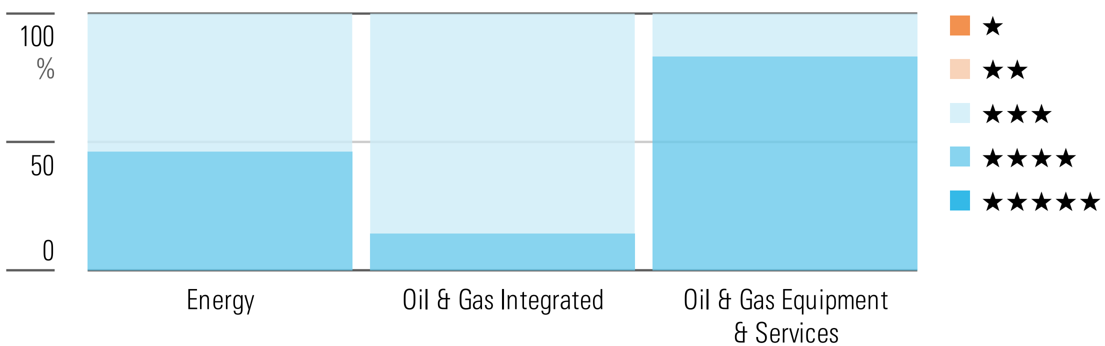
Shell is not completely abandoning power, but it certainly is trimming its sails. Capital spending will fall in 2023, with the bulk of reductions coming from marketing and renewables and energy solutions. To further enforce capital discipline and satisfy investors, Shell increased its payout ratio to 30%-40% of operating cash flow, from 30% previously, matching peer TotalEnergies, which was leading the group with a 35%-40% payout commitment.

Energy vs. the Morningstar European Index



Source: Morningstar. Data as of June 30, 2023.

Energy Star Rating Distribution by Industry



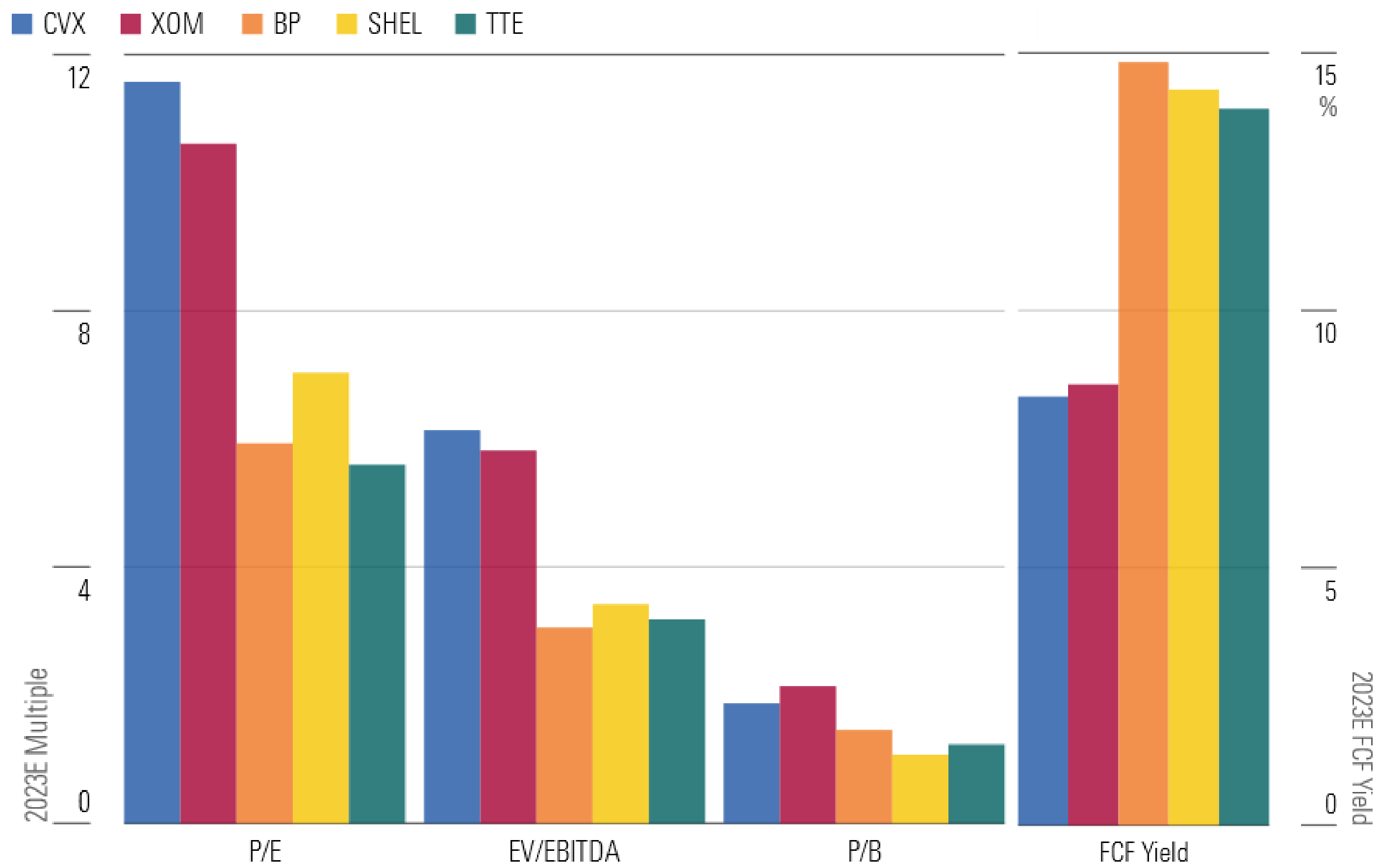
Source: Morningstar. Data as of May 31, 2023.

Markets Not Receptive To More Aggressive Low-Carbon Strategies

Shell CEO Wael Sawan called the updated strategy and guidance through 2025 a "sprint" for management and Shell's organisation to prove themselves during the next two years while getting a better sense of the macroeconomic environment.

This may leave some investors wary that Shell could revert to its spendthrift ways in pursuit of its unchanged long-term emission-reduction targets (for example, net-zero emissions by 2050 plan). Despite a history of reversing course, we do not think that is the case here. Shell is unlikely to ever match the hydrocarbon-focused strategy of ExxonMobil and Chevron, but there is plenty of room to improve returns and address low-return investments while offering an appealing energy transition alternative among integrated oils. By reigning in its low-carbon power ambitions, stemming the declines in its oil production, and emphasizing the value of its liquid natural gas and trading organisation, Shell could be that option. As such, we view the update positively and believe it will begin to change investors' perceptions, making Shell the preferred option among European integrated oils, even if it is not enough to earn a U.S. type of multiple.

European Shares Are Trading at a Modest Discount, but They Are Supported by a Relatively High Shareholder Yield



Source: PitchBook. Data as of June 20, 2023.

Energy | Top Picks

Name/Ticker		Rating	
Shell (SHEL)		★★★	Shell's new CEO Wael Sawan is reigning in spending, divesting low-return power assets, and increasing shareholder returns in a bid to close the valuation gap with U.S. peers. We do not think it will be entirely successful, but it is a step in the right direction. Meanwhile, the higher payout ratio of 30%-40% of cash flow brings it in line with peer TotalEnergies. Shell is unlikely to ever match the hydrocarbon-focused strategy of ExxonMobil and Chevron, but there is plenty of room to improve returns and address low-return investments while offering an appealing energy transition alternative among integrated oils. By reigning in its low-carbon power ambitions, stemming the declines in its oil production, and emphasizing the value of its LNG and trading organisation, Shell could be that option.
Price	**Fair Value**	**Uncertainty**	
GBX 2342.50	GBX 2,600.00	High	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
GBP 157.77	None	Standard	

Name/Ticker		Rating	
Schlumberger (SLB)		★★★	Industry leader SLB (formerly Schlumberger) offers broad exposure to the global oilfield services segment due to its highly diversified product portfolio with a tilt toward international markets. High demand for oilfield services gives service firms a good deal of pricing power, supporting elevated margins into 2024. SLB's leading-edge technological advancements—key drivers behind the firm's narrow moat—continue to distinguish the firm from peers: its myriad innovations consistently add value for customers, preserving SLB's ability to command premium pricing over and above the currently favorable operating environment.
Price	**Fair Value**	**Uncertainty**	
USD 49.47	USD 56.00	High	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
USD 70.01	Narrow	Exemplary	

Name/Ticker		Rating	
TotalEnergies (TTE)		★★★	TotalEnergies' latest strategic plan remains the same, aiming to achieve net-zero emissions by 2050 while delivering near-term financial performance. Its emissions-reduction goal is in line with many of its European peers, but in contrast to some, TotalEnergies does not plan a quick retreat from oil and gas. Instead, it plans to reduce emissions over time by expanding its ownership of renewable power assets. Its plan to return 35%-40% of cash flow to shareholders through the cycle, rates as one of the highest payouts among peers.
Price	**Fair Value**	**Uncertainty**	
EUR 52.55	EUR 61.00	High	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
EUR 127.36	None	Standard	

Financial Services

Henry Heathfield, CFA | henry.heathfield@morningstar.com
Johann Scholtz, CFA | johann.scholtz@morningstar.com
Niklas Kammer, CFA | niklas.kammer@morningstar.com

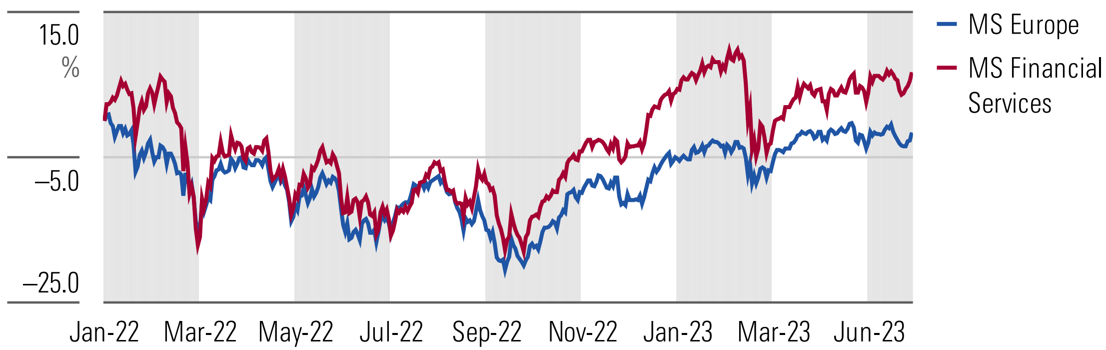
Sector Will Be Beneficiary of Structurally Higher Interest Rates Despite Short-Term Uncertainty

The Morningstar Financial Services Index has outpaced the Morningstar Europe Index since around September last year. Valuations have also partially recovered since the failure of Silicon Valley Bank and the takeover of Credit Suisse shook financial markets last quarter.

The economic backdrop in Europe continues to be challenging for central banks. Core inflation remains high, well above the 2% target, and some countries are already in, or on the brink of, a recession. For now, further interest-rate increases are the most likely scenario, although market participants are starting to shift their gaze forward to when economic growth becomes an issue and rates must be reduced markedly.

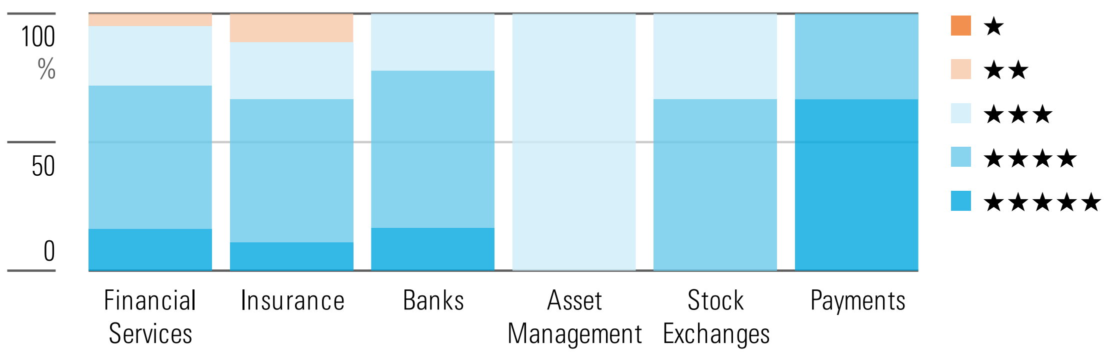
We believe the uncertainty around the timing and speed of these diverging scenarios playing out is clouding valuations. However, in the long term financial services will be a clear beneficiary of a nonzero and non-negative interest rate regime, even if rates come down from current levels. As such, we see multiple opportunities across our coverage. Overall, we believe that moats will become a differentiating factor again in separating the good from the great businesses. In banking, we expect to see banks with a large low-cost funding base, mostly retail-focused operations, as clear winners of the upcoming interest-rate regime. In insurance, superior standards of underwriting and the ability to pass higher prices onto customers will be deciding factors. Exchanges are well diversified and less affected by short-term uncertainty, but volatility generally plays in their favour.

Financial Services vs. the Morningstar European Index



Source: Morningstar. Data as of June 30, 2023.

Financial Services Star Rating Distribution by Industry



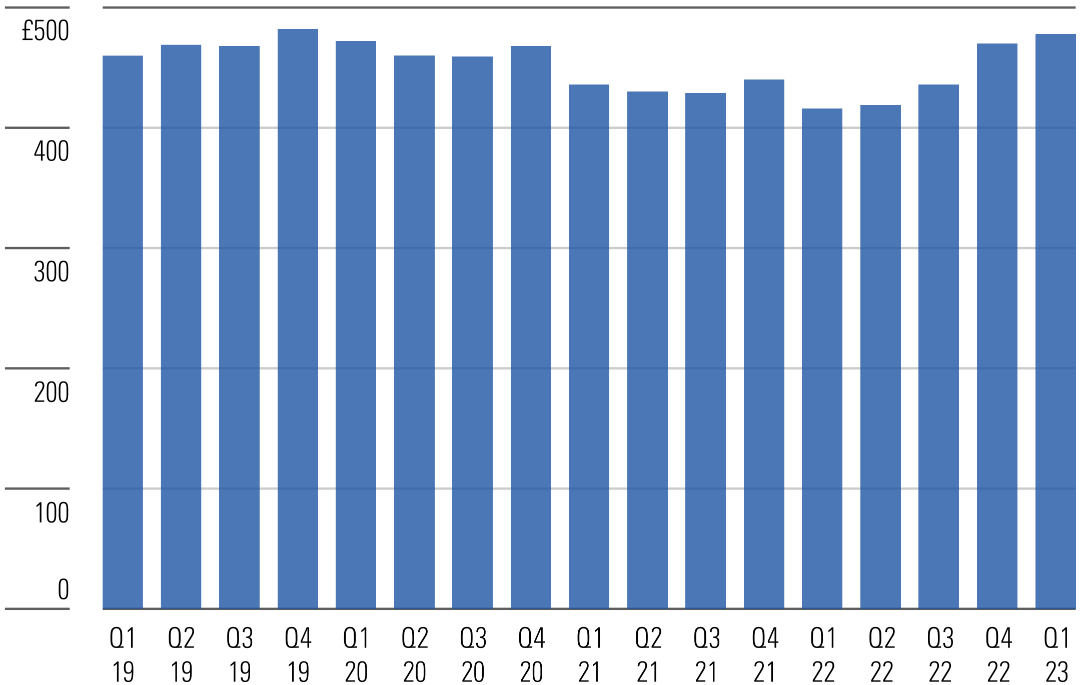
Source: Morningstar. Data as of May 31, 2023.

Motor Insurance Pricing Continues To Turn; Card Payments Continue To Rise

Motor insurance premiums within the U.K. continued to rise in the first quarter of this year, though at a slower pace than in the prior two quarters, increasing by 2%. We think individual motor insurers we cover have raised prices more than this.

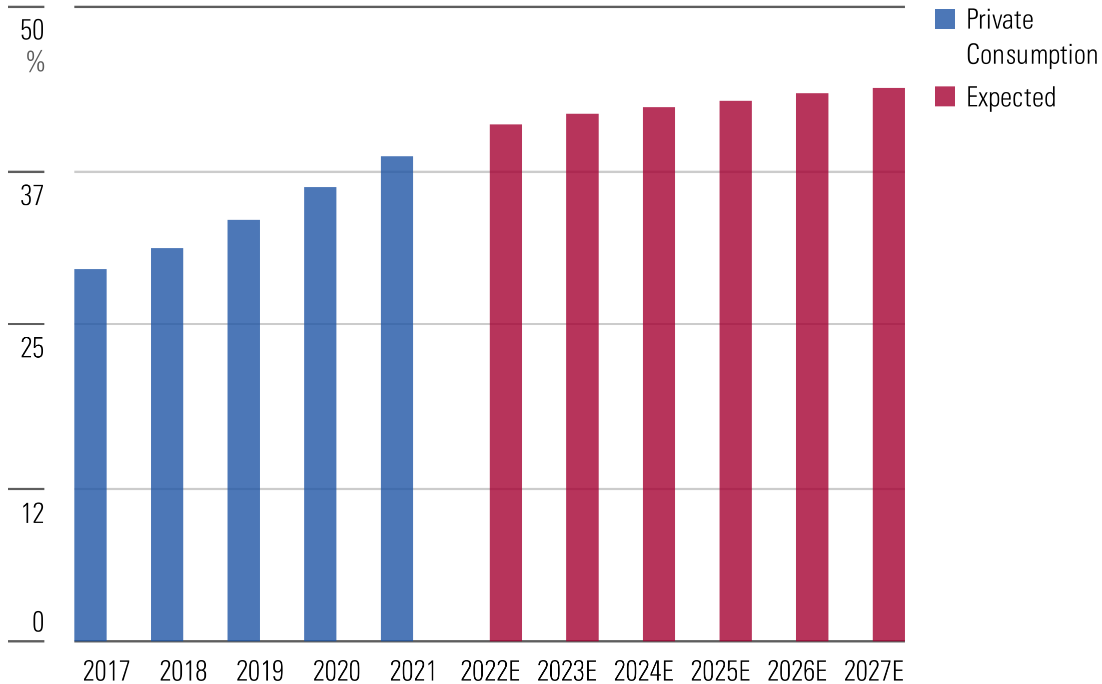
The shift from cash to cards is expected to continue in Europe, steadily growing the addressable market for in-store acquirers such as Worldline.

Comprehensive Motor Insurance Premium Tracker



Source: Association of British Insurers. Data as of May 31, 2023.

European Card Transaction Share



Source: Euromonitor. Data as of Mar.31, 2023.

Financial Services | Top Picks

Name/Ticker
Allianz (ALV)

Price	Fair Value	Rating
EUR 213.20	EUR 250.00	★★★★
Market Cap (B)	**Economic Moat**	**Uncertainty**
EUR 85.62	None	Medium
		Capital Allocation
		Exemplary

As our top pick, Allianz might not sound like the most obvious choice. As the largest European insurer that we cover by market cap, one could have the impression that this is a business with a large and heavy fixed-cost base, but we don't believe this to be the case. Allianz has been on a strong simplicity and digitalization drive over the past half-decade, managing to extract a large amount out of its cost base. This is a company that is exposed to rising inflation via claims, we believe the business also shows some unique pricing power characteristics in trade and credit insurance. Since the implosion of the Structured Alpha funds has not helped the brand, Pimco is Allianz's long-standing wholly-owned third-party asset manager with one of the best industry reputations and brand names.

Name/Ticker
Admiral (ADM)

Price	Fair Value	Rating
GBX 2,082.00	GBX 3,070.00	★★★★★
Market Cap (B)	**Economic Moat**	**Uncertainty**
GBP 6.10	Narrow	Medium
		Capital Allocation
		Exemplary

Narrow-moat Admiral is one of the best inflation-protected insurance businesses within our European insurance coverage. The company does write personal-line insurance and pricing tends to lag claims. This means that in an inflationary environment, underwriting standards will deteriorate before they start to improve. However, we believe Admiral has been able to pass through price increases that are generally ahead of the market and while full-year 2022 was a bad year for the industry, this year underwriting improvements will start to show. They may not be fully realized this year, but directionally there should be improvement and we believe Admiral is one of the best examples of superior standards of underwriting. On this basis we have awarded the company a narrow moat, with further improvements to come.

Name/Ticker
Worldline (WLN)

Price	Fair Value	Rating
EUR 33.50	EUR 91.00	★★★★★
Market Cap (B)	**Economic Moat**	**Uncertainty**
EUR 9.46	Narrow	High
		Capital Allocation
		Standard

High inflation is squeezing households' purses across Europe. Travel activity has been improving based on the lows in 2020 and 2021, but in particular long-distance travel remains a drag on performance for European payment providers. Against this backdrop, more muted volume and revenue growth could be on the cards over the coming quarters. That said, we believe these factors are fully priced in already. Moreover, we don't expect a structural change to the long-term growth drivers of this industry—a shift from cash to cards. In our view, Worldline currently offers the greatest upside and we believe investors should capitalize on its current share price weakness to enjoy the strong long-term growth prospects of this narrow-moat business.

Healthcare

Alex Morozov, CFA | alex.morozov@morningstar.com
Damien Conover, CFA | damien.conover@morningstar.com

Innovative Products and Defensive Nature Should Support Solid Results in Uncertain Times

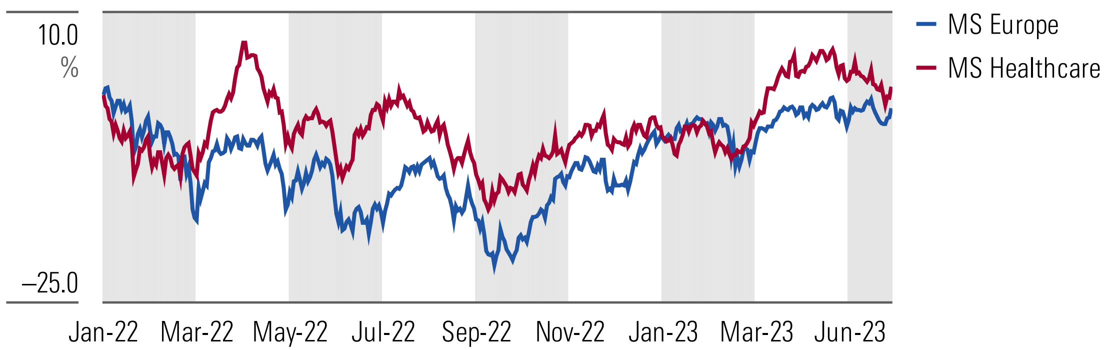
Healthcare's Core Fundamentals Remain Strong

Over the past 12 months, the Morningstar Healthcare Index has tracked slightly above the overall index. Healthcare continues to remain relatively immune to several macroeconomic challenges, including rising inflation and rising interest rates, along with banking system pressures. The innovation within the sector along with the defensive nature of healthcare products should support stable demand through economic cycles. While some healthcare firms may have a lag before passing along inflation-related price increases, we expect most of the healthcare firms in our coverage (especially those with moats) to maintain strong pricing power due to patents and high switching costs.

On valuation, we view the healthcare sector as undervalued. Our coverage trades below our overall estimate of intrinsic value. We see plenty of opportunities in healthcare, especially in biopharma, healthcare facilities, and diagnostics and research.

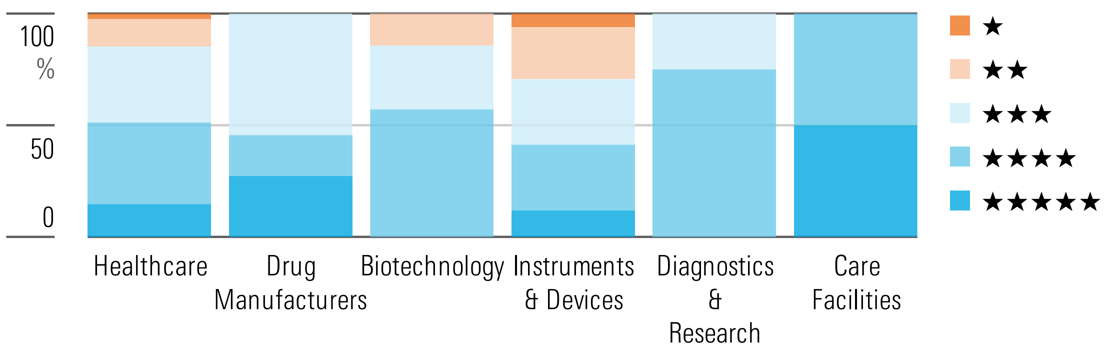
We see attractive valuations within multiple healthcare industries, including the largest healthcare industry by market capitalization, the biopharma group. The drug group holds several undervalued companies and looks well positioned for long-term growth driven by innovation in several therapeutic areas including oncology, immunology, and rare diseases.

Healthcare vs. the Morningstar European Index



Source: Morningstar. Data as of June 30, 2023.

Healthcare Star Rating Distribution by Industry



Source: Morningstar. Data as of May 31, 2023.

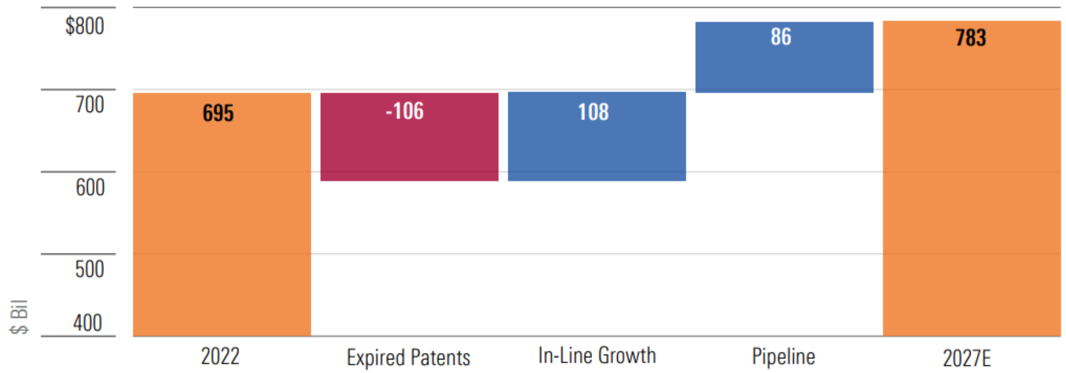
Life Sciences Well Positioned To Support Biopharma Drug Development

Beyond the drugmakers that will benefit from the 2.4% annual growth for the large-cap biopharma group over the next five years (see upper right chart), we see several life science companies benefiting from this growth.

Life science toolmakers that enable drug production often operate attractive businesses for two major reasons that investors find compelling. First, heavy regulation of the drug manufacturing process creates highly durable switching costs for end users and long potential revenue streams for life science toolmakers. Second, life science firms often benefit from broad exposure to biopharma growth without taking on much product-specific risk.

After the pandemic boom years, life science operations started resetting, causing shares to drop from recent peaks to reasonable, if not deeply discounted, levels. Wide-moat life sciences companies (circled in yellow in the lower right-hand side chart) look well positioned to benefit from supporting drug development over the next several years.

Leading Biopharma Firms Poised To Grow at 2.4% CAGR Through 2027



Source: Morningstar. Includes branded drug sales at AbbVie, Amgen, AstraZeneca, Bayer, Biogen, BioMarin, Bristol, Gilead, GSK, J&J, Eli Lilly, Merck, Novartis, Novo Nordisk, Pfizer, Regeneron, Roche, Sanofi as of March 15, 2023.

Medical Technology Switching Cost Durability Leaders

Source: Morningstar.

Healthcare | Top Picks

Name/Ticker		Rating	
Elekta (EKTA B)		★★★★★	Buoyed by growing demand for radiotherapy, wide-moat Elekta should enjoy strong sales momentum for the next decade. The RT industry has consolidated substantially over the past decade and the two main players are in a prime position to benefit from a market that we believe will grow in midsingle digits. Elekta has several things going for it in the near term, with the main catalyst being the adoption of its magnetic resonance/radiation therapy Unity technology. The company has sunk immense amounts of capital and time into the platform and should now start seeing steady order upticks as clinical data highlighting its advantage starts trickling in. The company hasn't executed well historically, but with a strong product portfolio it can finally make inroads into the lucrative North American market while continuing to see strong demand from emerging markets. Elekta trades at a material discount to its key rival as well as other medical technology firms.
Price	Fair Value	Uncertainty	
SEK 83.34	SEK 127.00	Medium	
Market Cap (B)	Economic Moat	Capital Allocation	
SEK 33.09	Wide	Standard	

Name/Ticker		Rating	
Fresenius (FRE)		★★★★★	Fresenius SE shares appear significantly undervalued because of the unprecedented challenges that the company's dialysis segment (Fresenius Medical Care) has been facing since 2021. Even with these concerns, we see a solid intermediate and long-term outlook for Fresenius SE, especially if the incoming management teams at Fresenius SE and Fresenius Medical Care can turn things around and if external factors such as labour pressures ease. The company's injectable therapies business (Kabi) is gearing up for potentially very large biosimilar launches in 2023 and beyond. The company's other segments appear solid. We think high-single-digit earnings growth compounded annually through 2026 remains possible at Fresenius SE. The shares appear to be discounting a much weaker scenario than that and overall, we still view Fresenius SE shares as some of the cheapest in our healthcare coverage.
Price	Fair Value	Uncertainty	
EUR 25.37	EUR 52.00	High	
Market Cap (B)	Economic Moat	Capital Allocation	
EUR 14.29	Narrow	Standard	

Name/Ticker		Rating	
Roche (ROG)		★★★★★	We don’t think the market fully appreciates Roche's drug portfolio and industry-leading diagnostics, which combined create maintainable competitive advantages. As the market leader in biotech and diagnostics, this Swiss healthcare giant is in a unique position to guide global healthcare into a safer, more personalised, and more cost-effective endeavour. The collaboration between its diagnostics and drug development groups gives Roche a unique in-house angle on personalised medicine. While COVID-19 and biosimilar-related headwinds will likely drive Roche’s growth into negative territory in 2023, we believe the fundamentals are strong and expect a recovery in 2024 as core blockbuster drugs continue to grow and pipeline drugs are launched.
Price	Fair Value	Uncertainty	
CHF 273.50	CHF 419.00	Low	
Market Cap (B)	Economic Moat	Capital Allocation	
CHF 220.72	Wide	Exemplary	

Industrials

Michael Field, CFA | michael.field@morningstar.com

A Mixed Earnings Season Offers Opportunities

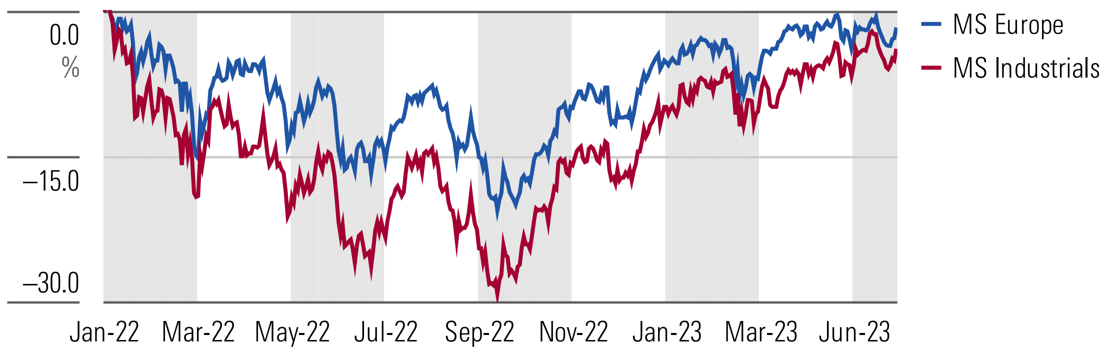
The industrials sector has lagged the wider Morningstar European Index so far in 2023 as concerns over an impending recession have had an impact on investors' willingness to invest in a sector with strong cyclical exposures.

Falling energy costs and China's reopening should be a boon this year, but persistent inflation and rising interest rates are also causing problems for some industrial firms, illustrated by a dichotomised earnings season, with clear winners and losers.

Valuations across the industrials sector are also very mixed, with segments like aerospace and defense highly valued, while opportunities still exist in electrical equipment and business services. In the latter, we highlight the testing, inspection, and certification companies. These companies are moaty by nature and highly resilient, with flexible cost bases, and they have the ability to pivot to areas of structural growth in the face of tough economic conditions.

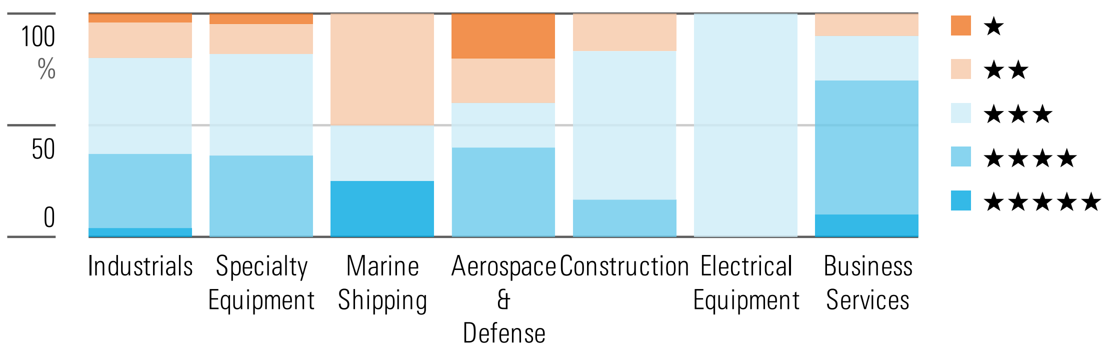
Another attractive area within the business services segment is shipping and logistics. With shipping rates bottoming as bottlenecks ease, the days of easy money have come to an end. But, for asset-light third-party logistics firms this isn't as devastating as many people think it is, with opportunities to profit as freight capacity shifts.

Industrials vs. the Morningstar European Index



Source: Morningstar. Data as of June 30, 2023.

Industrials Star Rating Distribution by Industry

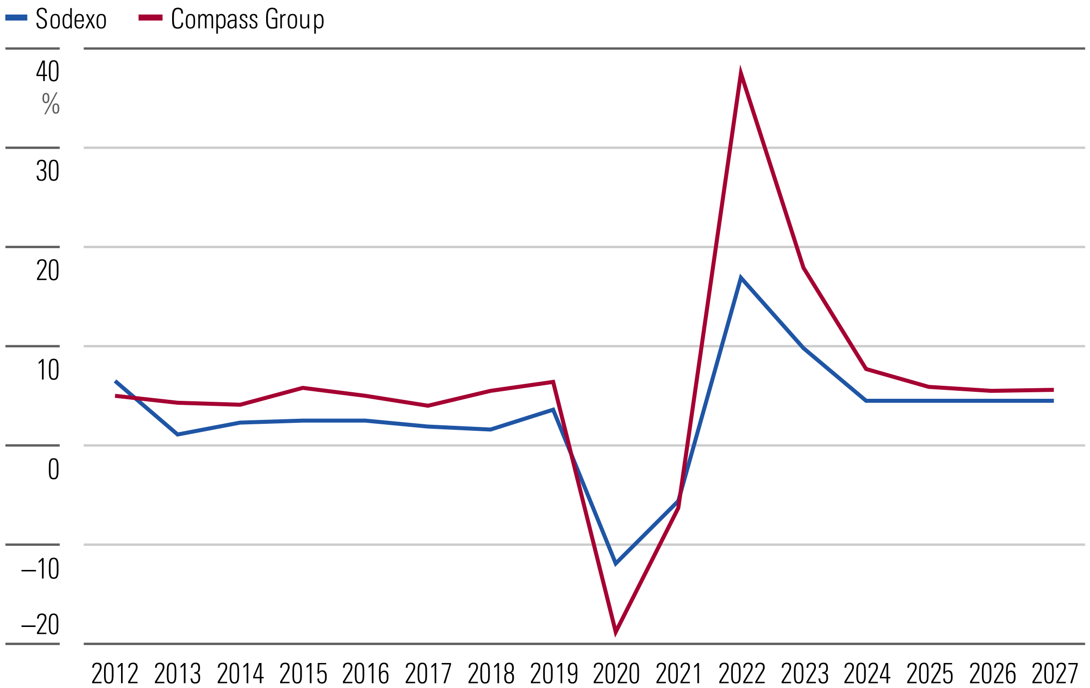


Source: Morningstar. Data as of May 31, 2023.

Catering Firms' Tailwinds May Continue Well Into 2024

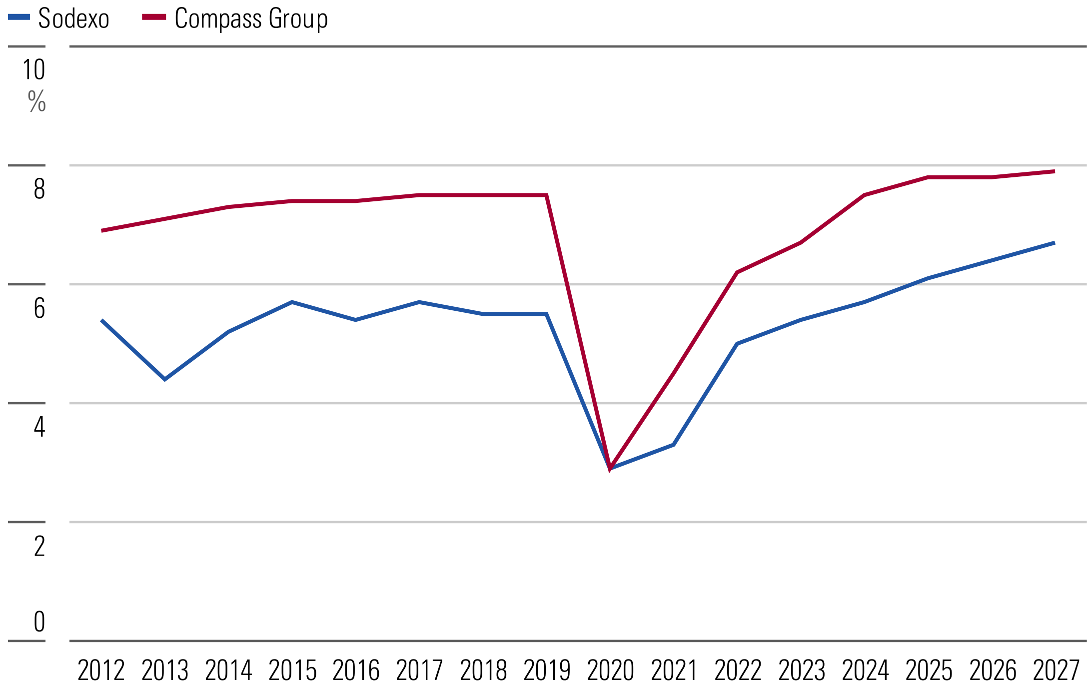
After a torrid lockdown period, the global caterers are back with a vengeance. Closures of smaller competitors combined with a renewed interest in outsourcing have meant strong levels of new business growth, bolstered by growing volumes from existing customers. Revenue is already above prepandemic levels for Compass and Sodexo and we expect operating margins for both to recover in 2023/24.

Revenue Growth Has Spiked for the Global Caterers



Source: Company statements. Morningstar estimates June 2023.

Operating Margins Have Largely Recovered To Prepandemic Levels



Source: Company statements, Morningstar estimates June 2023.

Industrials | Top Picks

Name/Ticker		Rating	
Sodexo (SW)		★★★★	The number-two caterer in the world, the stock’s narrow moat is underpinned by strong switching costs with client retention north of 95%. The stock's current valuation is back to prepandemic levels, but what investors are missing is the potential for supernormal revenue growth for the next couple of years, combined with a greater ceiling for operating margin growth, following a complete overall of the company's cost base during the pandemic.
Price	**Fair Value**	**Uncertainty**	
EUR 100.85	EUR 118.00	Medium	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
EUR 14.73	Narrow	Standard	

Name/Ticker		Rating	
Intertek (ITRK)		★★★★★	Currently, Intertek is the most attractive stock in the testing, inspection, and certification sector, and trading at a rare discount to our fair value estimate. Although the company is still recovering from the pandemic and Chinese industrial disruptions due to COVID-19 lockdowns in the first half of 2022, the company is already showing positive signs of recovery in 2023.
Price	**Fair Value**	**Uncertainty**	
GBX 4,265.00	GBX 5,700.00	Low	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
GBP 6.88	Narrow	Standard	

Industrials | Top Picks

Name/Ticker		Rating	
Maersk (MAERSK B)		★★★★	The days of easy money have come to an end as freight rates bottom and supply chain bottlenecks are finally unblocked. However, Maersk has made a small fortune over the last few years and has been wise in its capital deployment, paying down debt and expanding its logistics business. While revenue and profits must decline from here, we believe the market is overly negative on the outlook for the business.
Price	**Fair Value**	**Uncertainty**	
DKK 11,975.00	DKK 20,000.00	High	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
DKK 201.231	None	Standard	

Name/Ticker		Rating	
Assa Abloy (ASSA B)		★★★★	Assa Abloy screens attractively with investors presently underappreciating the secular growth opportunity in front of the global leader in locking solutions and systems. Indeed, we expect revenue to grow an average of 8% in the medium term as adoption rates of electromechancial locking systems hasten—particularly in emerging markets—and the current industrywide shift toward software-driven locking products continues. The continuation of Assa Abloy's tuck-in acquisition programme—which targets local champion lock brands and deliver synergies by bringing them into larger-scale assembly plants and distribution—is expected to further augment organic growth prospectively.
Price	**Fair Value**	**Uncertainty**	
SEK 259.00	SEK 300.00	Medium	
Market Cap (B)	**Economic Moat**	**Capital Allocation**	
SEK 287.69	Wide	Standard	

Utilities

Tancrede Fulop, CFA | tancrede.fulop@morningstar.com

Headwinds Look Excessively Priced In

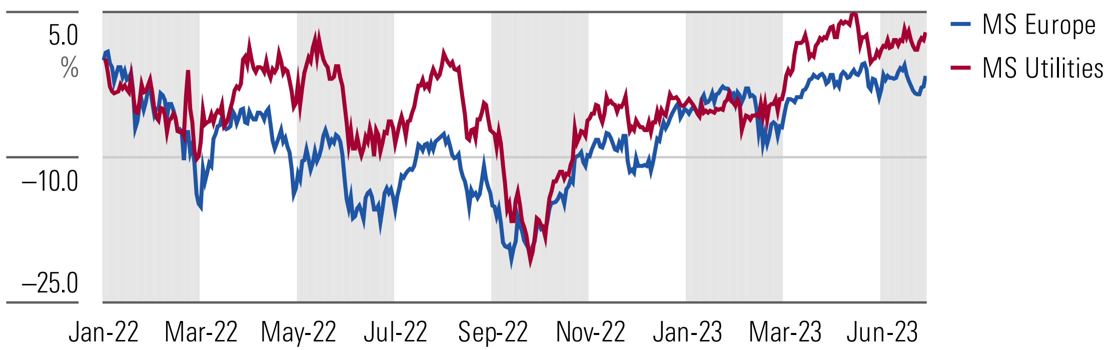
The Morningstar Developed Markets Europe Utilities Index increased by 12% year to date, slightly ahead of the broader index. Utilities were supported by a quieter regulatory backdrop after a hectic 2022 and strong earnings.

Most integrated European utilities reported record 2022 profits because of elevated power prices. Networks also performed well owing to the indexation of most of their revenue to inflation. This strong set of earnings reflects the favourable positioning of the sector against high inflation.

Utilities that posted the strongest results in 2022 are the most sensitive to power prices. Accordingly, their earnings will recede in 2023 on the implementation of various power price caps across Europe and the decline of power prices driven by the easing of the energy crisis, which will more than offset the rollover of negative hedges. Integrated utilities with high international exposure and more limited sensitivity to European power prices should deliver earnings growth in 2023 and beyond thanks to investments in networks and renewables. Likewise, purely renewable players should also deliver earnings growth in the coming years thanks to capacity additions.

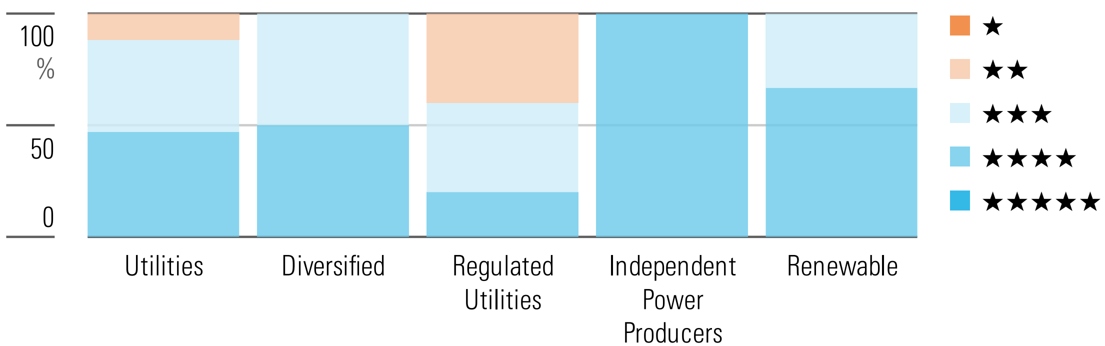
Overall, we view the sector as undervalued with a median price/fair value estimate ratio of 0.92. Investors are still too focused on the sector's headwinds, political risks, rising interest rates, and rising construction costs of renewable projects. We believe these headwinds are easing.

Utilities vs. the Morningstar European Index



Source: Morningstar. Data as of June 30, 2023.

Utilities Star Rating Distribution by Industry

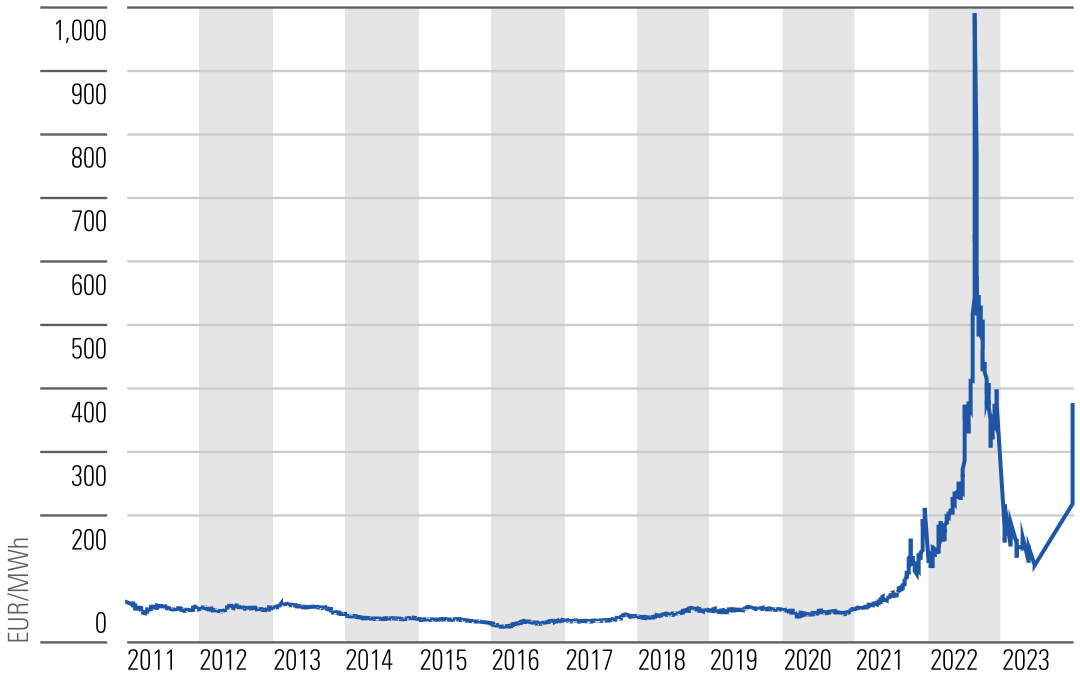


Source: Morningstar. Data as of May 31, 2023.

Relative Dividend Yield Is Falling, but Remains an Attractive Source of Income

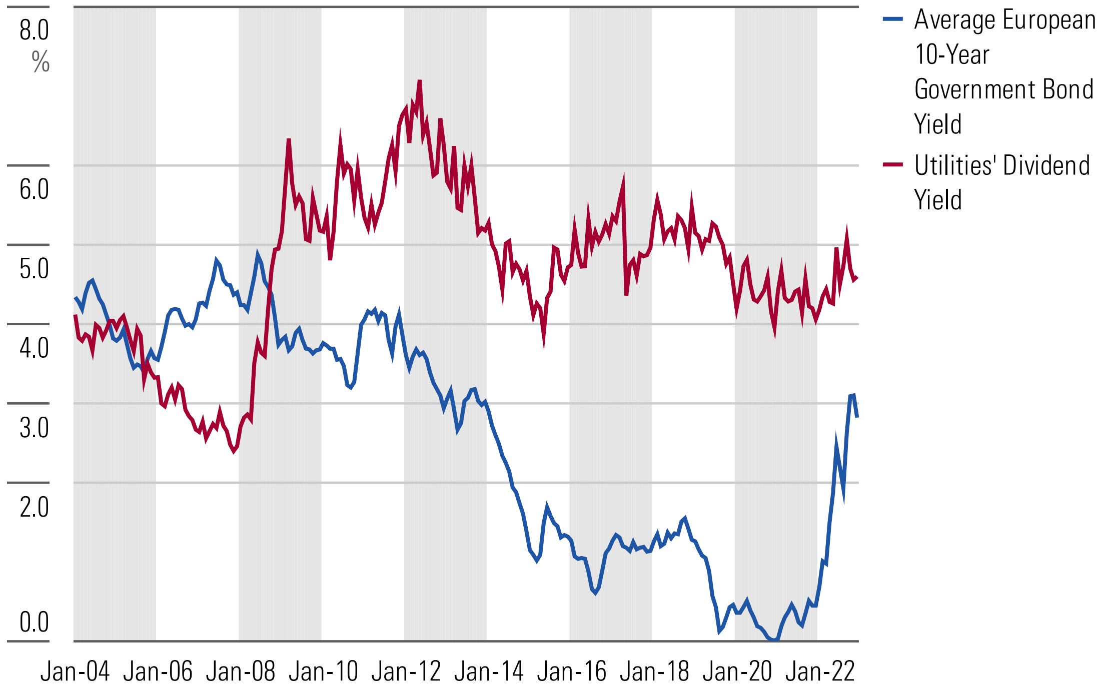
The sector's 4.3% median trailing dividend yield is below the 4.6% historical median. Likewise, the 105-basis-point premium to the average of the main European government bond yields is way below the 270-basis-point historical median.

German Power Prices Remain Well Above Preenergy Crisis Levels



Source: Morningstar commodities. Data as of June 16, 2023.

European Utilities' Yield Premium To Government Bond Yields Has Diminished



Source: Morningstar. Data as of June 16, 2023.

Utilities | Top Picks

Name/Ticker		Rating	
Enel (ENEL)		★★★★	Enel shares have rallied strongly since their October 2022 lows as the company maintained its dividend and the election of a Giorgia Meloni-led government has reassured investors. We believe the rally will continue as earnings rebound after a challenging 2022. The firm should continue to execute its disposal plan at attractive prices, that are well above the conservative guidance of an average enterprise value/EBITDA of 8 times. The dividend is secured, despite what the 7% current dividend yield suggests. Investors did not like the politically driven replacement of CEO Francesco Starace by Flavio Cattaneo, but we believe his experience as CEO of Terna, the Italian grid operator, makes him very suitable for the role.
Price	Fair Value	Uncertainty	
EUR 6.17	EUR 7.50	Medium	
Market Cap (B)	Economic Moat	Capital Allocation	
EUR 62.66	None	Standard	

Name/Ticker		Rating	
ENGIE (ENGI)		★★★★	Engie’s undervaluation reflects investors’ distrust of the company, based on a bad capital allocation track record. We think this scepticism is overdone as the company is delivering ahead of its targets with accelerated investments in renewables and disposals of noncore businesses at a high premium. After record 2022 profits, earnings are declining this year in the wake of lower power prices. Further out, high renewable investments will support earnings and dividend growth. Last, Engie has limited sensitivity to rising interest rates thanks a leverage well below peers. A recent extension of a nuclear power plant contract with the Belgian government also provides increased visibility of revenue for investors.
Price	Fair Value	Uncertainty	
EUR 15.23	EUR 17.00	Medium	
Market Cap (B)	Economic Moat	Capital Allocation	
EUR 36.86	None	Standard	

Name/Ticker		Rating	
RWE (RWE)		★★★★	RWE is the second-biggest offshore wind company behind Orsted. With the acquisition of ConEd's clean energy business, it became the fourth-largest renewable player in the U.S., a very favourable market for renewables since the adoption of the Inflation Reduction Act. The recent advance of the coal exit in Germany to 2030 could help reduce the discount of RWE's renewable operations versus peers. Last, RWE has one of the highest exposures to European power prices and clean spark spreads thanks to the highly liberalised share of its renewable volumes and combined-cycle gas turbines. Last, it benefits from commodity price volatility thanks to its trading divison.
Price	Fair Value	Uncertainty	
EUR 39.87	EUR 53.00	Medium	
Market Cap (B)	Economic Moat	Capital Allocation	
EUR 29.66	None	Exemplary	

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