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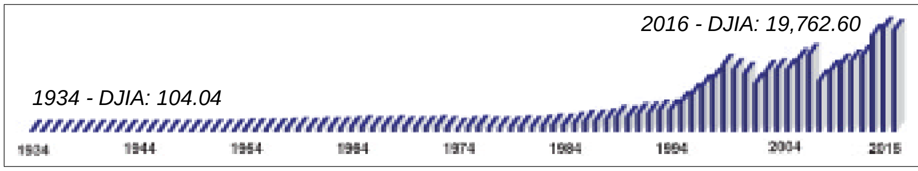
MARKET DIGEST



WEDNESDAY, OCTOBER 25, 2017
OCTOBER 24, DJIA 23,441.76
UP 167.80

Good Morning. This is the Market Digest for Wednesday, October 25, 2017, with analysis of the financial markets and comments on **Norwegian Cruise Line Holdings Ltd., 3M Co., Adobe Systems Inc., KB Home and Public Service Enterprise Group Inc.**

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* Initiation of Coverage: Norwegian Cruise Line Holdings Ltd.: Launching coverage with a BUY rating and $68 target (John Staszak)
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MARKET REVIEW:

The technical setup remains favorable, even with a few ripples in the overall trend. Among our market indicators, we've seen a decline in our technical composite, despite the major equity benchmarks hitting record highs. This was due to a moderate drop in NYSE breadth from a decline in the number of stocks above their 150-day moving average and in net advance/decline issues.

Our CBOE trading measures also moved lower following a jump in put/call hedging, though partly offset by an improvement in net up/down volume. Still, composite technicals remain in bullish territory.

Our strategic composite inched up a bit of late but remains in neutral territory. Market internals saw a small drop in transports versus industrials, and a dip in small-caps — but Industrials held up better than Utilities or Staples. External indicators were helped by an uptick in crude oil, which offset a pullback in industrial commodity prices.

Though an upside surprise is possible, 3Q17 could be the only quarter in 2017 in which EPS fails to grow by double-digits. Will that be a problem for stock performance? We suggest no, based on past 3Q earnings season performance.

We looked at all 3Q reporting periods (using October 15 to November 15) since 1980 to measure performance for average earnings seasons compared with better-than-average earnings seasons. The mid-October to mid-November period captures at least 80% of the EPS season.

For all mid-October to mid-November periods from 1980 through 2016, the S&P 500 has averaged capital appreciation of 1.0%. The index has risen in 25 out of 37 years for a 68% win rate. And no wonder: the average third-quarter EPS growth rate over that span has been 6.6%.

Since 2000, stocks have experienced two wrenching bear markets: the internet implosion of 2000-02, and the housing crisis-cum-recession of 2007-09. Still, for all years since the millennial turn, 3Q EPS growth has averaged 4.8%; and stock performance has averaged 1.3%.

In general, above-average EPS growth begets above-average stock performance. We screened all 3Q reporting seasons since 1980 for periods with 5%-plus EPS growth. For these years only, capital appreciation between the October and November mid-months has averaged 3.0% on the S&P 500. Given this year's nearly 8% EPS growth forecast, that is a positive sign, particularly with the index already up 1% since mid-October. (Jim Kelleher, CFA, Director of Research)

NORWEGIAN CRUISE LINE HOLDINGS LTD. (NGS: NCLH, $54.66)................................... BUY

NCLH: Launching coverage with a BUY rating and $68 target

* Founded in 1966 and based in Miami, this mid-cap cruise company offers cruises to 510 destinations worldwide.
* Norwegian plans to spend $1 billion annually to construct new ships through 2020. The additional capacity should boost revenue and margins, as new ships generate more revenue per berth.
* The shares appear attractively valued given the company's clean balance sheet, experienced management team, expanding fleet, and prospects for strong earnings growth.
* NCLH shares have outperformed since their IPO, but have recently pulled back in price, offering investors a favorable entry point.

ANALYSIS

INVESTMENT THESIS

We are launching coverage of Norwegian Cruise Line Holdings Ltd. (NGS: NCLH) with a BUY rating and a $68 target price. NCLH is smaller than the other cruise lines that we follow (Royal Caribbean and Carnival, both BUY-rated) and, in our view, has more room to increase capacity over the next several years. The company recently added the Norwegian Joy in the Chinese market, returning to China after a long absence. It also plans to spend $1 billion annually to construct new ships through 2020. The additional capacity should boost revenue and margins, as new ships generate more revenue per berth. Norwegian should also continue to benefit from its clean balance sheet and experienced management team, as well as from growing demand for cruise vacations. The company notes that bookings remain strong, and has been able to boost ticket prices and occupancy over the last year. On valuation, the stock appears attractive at just 13.1-times our 2017 EPS estimate, well below the average multiple of 21.0 for hotel and cruise line companies. Our target price of $68 implies a potential total return of 27% from current levels.

RECENT DEVELOPMENTS

NCLH shares have risen more than 27% thus far in 2017. However, they fell 5.7% on October 19 following an analyst downgrade, which expressed concerns about slowing cruise demand in China. We think the selloff was excessive and believe that it offers a buying opportunity for patient investors.

On August 8, Norwegian reported adjusted second-quarter EPS of $1.02, up from $0.85 in the prior-year period. EPS topped the consensus estimate of $0.97 and management's guidance of $0.95. The positive earnings surprise reflected stronger-than-expected net yields and moderately lower net cruise costs excluding fuel, offset in part by higher-than-anticipated fuel costs.

Second-quarter revenue rose 13% to $1.3 billion. The increase reflects the addition in 2016 of two new ships, the Oceana Sirena and the Seven Seas Explorer, as well as stronger ticket pricing and higher onboard revenue. Reported net yields rose an impressive 7.2% (up 8.1% in constant currency), above our estimate of 5% growth. In constant currency, net cruise costs excluding fuel were also lower than expected, rising 2.6% year-over-year on a reported basis (and 2.7% in constant currency). However, fuel costs of nearly $87 million were $3 million higher than we had forecast. Below the line, interest expense fell more than $4 million to $64 million, while the tax rate rose by 150 basis points to 3.3%. The share count rose slightly from the prior year to 229 million.

In its 2Q earnings release, management said that bookings have been exceptionally strong, and that pricing and occupancy have both risen at a mid-single-digit rate thus far in the second half the year.

For all of 2016, revenue rose 4.3% to $16.4 billion, while EPS rose to $3.41 from $2.88 a year earlier.

EARNINGS & GROWTH ANALYSIS

In 3Q17, Norwegian Cruise Lines expects net yields in constant currency to increase 1.75% from the prior year (up 2.0% on a reported basis). The modest increase in net yield reflects the recent addition of the Seven Seas Explorer and the Oceana Sirena. According to management, excluding the additional capacity, net yields would have been up more than 5%. Management expects net cruise costs, both in constant currency and as reported, to rise slightly in 3Q17.

The company will report 3Q results in early November. The Street currently expects earnings of $1.83 per share on revenue of $1.65 billion. However, given the company's positive surprises over the past six quarters, we look for above-consensus earnings of $1.88 per share on revenue of $1.67 billion.

For 2017, management has raised its net yield estimate in constant dollars by 150 basis points to 4.25% (up 4.0% on a reported basis). It expects net cruise costs excluding fuel to rise 1.75% in constant currency, up from its prior forecast of 1.5%, due in part to the addition of the Norwegian Joy in the Chinese market. Based on these projections, management projects 2017 EPS of $3.93-$4.03, up from its prior forecast of $3.79-$3.89. Given recent positive earnings surprises, we project full-year EPS of $4.10, above the consensus forecast of $4.06. We are also setting a 2018 estimate of $4.70, above the consensus of $4.64.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on NCLH is Medium, the middle rank on our five-point scale.

Norwegian's 2Q17 operating margin rose 180 basis points to 26.5%, reflecting favorable operating leverage. Operating income covered interest expense by a factor of 4.3, up from 3.3 in the prior-year period, as operating income grew and interest expense decreased. The debt/capital ratio at the end of the second quarter was 55.0%, below the industry average of 58.7%.

The company does not pay a dividend and, in view of its need to finance additional capacity, we do not expect it to initiate one in the near term.

MANAGEMENT & RISKS

Frank Del Rio became the company's CEO in January 2015 following the resignation of former CEO Kevin Sheehan. Mr. Del Rio had been president and CEO of Prestige Cruise Holdings, which NCLH acquired at the end of 2014.

Norwegian Cruise Lines' business is at risk from terrorism or the threat of terrorism, which could cause travelers to cancel cruise vacations. Hurricanes are also a risk. The company's results could also be hurt by heightened safety concerns following ship malfunctions or by an increase in fuel costs. In addition, the company faces risks from general economic weakness, especially in the U.S., where it generates most of its revenue. A strong U.S. dollar could also temper international revenue growth.

COMPANY DESCRIPTION

Founded in 1966 and based in Miami, Norwegian Cruise Line Holdings offers cruises to approximately 510 destinations worldwide. NCLH sells its cruises through independent travel agents, wholesalers, and tour operators. The company went public on January 17, 2013, closing at $24.89. In 2014, Norwegian Cruise Lines acquired Prestige Cruise Holdings, the parent company of Oceania Cruises and Regent Seven Seas. As of May 10, 2017, it operated a fleet of 25 ships with approximately 50,400 berths under the Norwegian Cruise Line, Oceania Cruises, and Regent Seven Seas brands.

INDUSTRY

We have lowered our rating on the Consumer Discretionary sector to Market-Weight from Over-Weight. On top of the well-documented pressures on traditional retailers in this sector, the housing market is facing pressure from insufficient home supply and the new model year has failed to trigger higher purchases of new vehicles. While demand for big ticket consumer goods falters, we expect consumer discretionary investors to focus on leisure-related stocks. The sector accounts for 12.3% of the S&P 500. We think investors should consider allocating 12%-13% of their diversified portfolios to the group. Over the past five years, the weighting has ranged from 8% to 13%. The sector underperformed in 2016, with a gain of 4.3%, after outperforming in 2015, with a gain of 8.4%. It is underperforming thus far in 2017, with a gain of 9.6%.

Consumer Discretionary earnings are expected to increase 11.0% in 2018 and 4.8% in 2017 after rising 9.4% in 2016 and 9.9% in 2015. On valuation, the 2018 projected P/E ratio is 18.9, above the market multiple of 17.1. The sector's debt ratios are high, with an average debt-to-cap ratio of 52%. Yields are below average at 1.4%.

VALUATION

In our view, the current NCLH share price inadequately reflects prospects for strong net yields (management projects 4.25% growth this year), additional cruise capacity, and relatively high margins. We also believe that a recent pullback offers patient investors a buying opportunity. NCLH is trading at 13.1-times our 2017 EPS estimate, well below the average multiple of 21.0 for other leisure companies. We expect strong cruise demand, supply discipline and management's cost-cutting efforts to boost earnings in the coming quarters and are setting a price target of $68. Our target, if achieved, offers investors the prospect of a 27% return.

On October 24, BUY-rated NCLH closed at $54.66, up $0.94. (John Staszak, CFA, 10/24/17)

3M CO. (NYSE: MMM, $234.65).. BUY

MMM: Raising target to $260

* MMM shares have outperformed the market over the past quarter, with a gain of 13% compared to a 4% advance for the S&P 500.
* On October 24, MMM posted 3Q17 earnings that topped consensus expectations, and management raised its full-year guidance.
* We have raised our EPS estimates for both 2017 and 2018.
* The shares are not cheap, but we think they deserve to trade at a premium to those of other industrial companies given 3M's high margins and returns on invested capital.

ANALYSIS

INVESTMENT THESIS

Our rating on 3M Co. (NYSE: MMM) is BUY with a target price of $260, raised from $220. This leading blue-chip industrial company appears poised to deliver low to mid-single-digit organic sales growth, which, along with margin expansion and a share buyback program, has the potential to drive double-digit earnings growth over the course of a five-year business cycle. Management is transparent about its long-term financial goals and provides regular updates that allow investors to check milestones. Management is also clearly focused on generating shareholder value, and consistently raises the dividend and buys back stock. 3M should get an earnings boost from improving global economic conditions and a stable-to-weaker dollar in 2017, as well as from new products generated through its focus on innovation. The shares are not cheap, but we think they deserve to trade at a premium to those of other industrial companies given 3M's high margins and returns on invested capital. The shares are suitable as a core holding for diversified portfolios.

RECENT DEVELOPMENTS

MMM shares have outperformed the market over the past quarter, with a gain of 13% compared to a 4% advance for the S&P 500. Over the past year, the shares have also outperformed, rising 38% while the S&P 500 has gained 19%. MMM has outperformed the industry ETF (IYJ) over the past year, as well as over the trailing 5- and 10-year periods. The beta on MMM is 1.09.

On October 24, MMM posted 3Q17 earnings that topped consensus expectations, and the stock price rose 7%. Revenue of $8.2 billion rose a sequentially stronger 6.6% year-over-year on an organic, constant-currency basis. Operating income rose 7%, as the GAAP operating margin grew 30 basis points to 25.0%. GAAP EPS rose 8% to $2.33. In the first nine months, the company earned $7.07 per share.

Along with the 3Q results, management raised its 2017 EPS guidance to $9.00-$9.10 from $8.80-$9.05, implying 11% year-over-year growth at the midpoint of the range.

The company continues to position its portfolio of businesses for growth. In 1Q, it announced that it would acquire Scott Safety, a leading safety solutions company owned by Johnson Controls (JCI: HOLD), for $2 billion. Management also plans to divest its Identity Management business. The company invested $178 million in acquisitions in 2Q. It will continue to pursue acquisitions in an effort to accelerate revenue growth and boost margins. Management expects to spend the equivalent of $0.20-$0.25 per share on acquisitions in 2H17.

EARNINGS & GROWTH ANALYSIS

3M has five primary business segments: Industrial (34% of 3Q sales),which serves the automotive and aerospace industries, among others; Safety and Graphic (18%); Electronics and Energy (17%); Healthcare (18%), which focuses on drug delivery systems, food safety and health information systems; and Consumer (15%), including products for home improvement, consumer healthcare, stationery and office. Third-quarter results by segment are summarized below.

In the Industrial segment, organic sales grew a solid 6.1% from the prior year. This was the fourth consecutive quarter of growth. The best-performing business lines were once again advanced materials and adhesives, along with separation and purification. The strength in advanced materials is a positive sign, as this business had lagged during the energy industry downturn. Sales grew in all geographic regions, led by Asia Pacific and Latin America/Canada. Adjusted for strategic investments, the 3Q operating margin fell 30 basis points to 22.2%. Looking ahead, we expect to see continued top-line growth in this segment into 2018, though not likely at the third-quarter's 6.1% rate.

In the Healthcare segment, organic sales rose a solid 6.9% from the prior year. Growth was once again driven by sales of drug delivery systems, medical consumables, and food safety products. The segment continues to post strong sales in emerging markets, including Latin America and China. The non-GAAP operating margin, adjusted for strategic investments, was 32.2%, up 70 basis points from the prior year. Looking ahead, we expect to see low single-digit top-line growth and roughly flat margins for the next few quarters.

In Electronics and Energy, organic sales rose 13.2%. Electronics-related sales were up a strong 18%, while Energy-related sales reversed course and rose 2%. On a geographic basis, sales growth was the strongest in the Asia Pacific region (up 20%), followed by Latin America/Canada (up 6%). Sales were flat to slightly lower in the U.S. and EMEA. Adjusted for strategic investments, the segment operating margin was a healthy 28.2%. This segment is recovering in 2017.

Safety and Graphics posted a solid 6% year-over-year increase in organic sales. Sales of personal safety and transportation safety products and roofing granules rose, while sales of commercial solutions declined. Organic sales rose in all regions, led by an 11% increase in Asia. The adjusted operating margin rose 260 basis points to 26.8%. The revenue outlook for this group remains positive, driven by strong fundamentals in the housing and construction markets.

In the Consumer segment, organic revenue grew 2.2% from the prior year. The segment posted growth in home improvement, healthcare, and home care products, while sales of stationery and office products declined. By geography, sales were weak in the U.S. but up 7% in the Asia Pacific region. Adjusted for strategic investments, the segment operating margin was 25.9%. Looking ahead, we expect low single-digit sales growth and note that margins may face pressure as the company increases advertising and merchandising spending.

Based on recent trends in 3M businesses — improving in Industrial and Electronics & Energy, stable in Healthcare, challenging in Consumer — we are raising our 2017 EPS estimate to $9.07 from $8.98. Our estimate is above the midpoint of management's guidance range and implies 11% growth from last year. We are raising our 2018 estimate to $9.70 from $9.60, implying growth of 7%, slower than in 2017 based on expected sales challenges. Our five-year earnings growth rate forecast remains 10%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on 3M is Medium-High, the second-highest rank on our five-point scale. The company receives above-average marks on our three main criteria of debt levels, fixed-cost coverage and profitability.

Management focuses on generating strong cash flow. The company is targeting a 2017 free cash flow/net income ratio of 95%-105%. The ratio was solid in 3Q, at 100%.

3M has a share buyback program. Management expects share buybacks to boost EPS by 3% over time, but recently lowered its 2017 share repurchase outlook from $2.5-$3.5 billion to $2.0-$3.5 billion. Management says that limiting buybacks will provide more financial flexibility as the company evaluates potential M&A opportunities.

3M pays a dividend. In February 2017, it raised its quarterly payout to $1.175 per share, or $4.70 annually, for a yield of about 2.1%. This was the 59th consecutive year of annual dividend increases for the company. We think the dividend is secure and poised to grow. Our dividend estimates are $4.72 for 2017 and $5.10 for 2018.

MANAGEMENT & RISKS

Inge Thulin is the CEO of MMM and has served in the role since 2012. Mr. Thulin has worked at 3M since 1979.

According to Mr. Thulin, the company is using three strategic levers to position itself for the future. The first is portfolio management, as 3M pursues acquisitions and reorganizes its business segments.

The second is investing in innovation. 3M plans to increase R&D investments to approximately 6% of sales by the end of 2017. CEO Thulin sees investments in innovation as critical to gaining a competitive edge.

The third lever is business transformation. 3M has a new ERP system that has now been rolled out in five countries. Ultimately, the new system will leverage 3M's size and scale to drive productivity and improve customer service.

MMM typically sets five-year goals. Its 2016-2020 financial targets are: earnings growth of 8%-11%, organic revenue growth of 2%-5%, ROIC of 20%, and FCF conversion of 100%. These compare with its 2013-2017 financial targets, which were: earnings growth of 9%-11%, organic revenue growth of 4%-6%, ROIC of about 20%, and FCF conversion near 100%.

On December 13, 2016, the MMM management team met with analysts and investors in New York. Our key takeaways from the meeting are summarized below.

—With top-line growth a challenge, management continues to focus on cost cutting. The company's business transformation "lever for growth" is expected to capture $500-$700 million in annual savings and $500 million in working capital improvement by 2020, with most of the improvement to come from supply-chain optimization. Management expects $50 million in operating income value in 2016 and $100-$150 million in 2017.

—As part of the transformation, the company has consolidated its business segments from 40 to 25, and from six segments to five business groups to reduce waste, foster continuous improvement, and drive down costs.

—On a segment basis, the Healthcare and Consumer segments are expected to lead organic growth in 2017, with a drag from Electronics and Energy and solid performance from Safety and Graphics, and Industrial. A modest turnaround is expected in Oil and Gas.

—Geographically, LatAm and Canada are expected to lead, with a drag from EMEA and decent performance in the U.S. and APAC.

—Going forward, investors should not expect to see slower dividend growth than in recent years. Now that a target payout ratio has been reached, the dividend is expected to increase at the same pace as EPS.

—In terms of capital allocation in 2017, the company expects to use $1.8 billion for R&D, $1.3-$1.5 billion for capital expenditures, $2.0-$3.5 billion for share repurchases, and $0.3-$0.5 billion for pension obligations, in addition to spending on M&A.

Investors in MMM shares face risk. The company grows organically as well as through M&A, introducing integration risks. The company may also see limited future benefits from its cost-saving initiatives, which it has used to boost earnings in a weak economy. 3M is consistently ranked near the top of lists of the most innovative companies and relies on a history of product innovation to drive revenue and earnings. If it becomes unable to develop and market new products, results could suffer. The company could also be forced to make larger-than-expected pension plan contributions if investment returns are weak.

With approximately 65% of revenue generated outside the U.S., MMM’s results are typically linked to global economic trends. Recently, the global economic outlook has turned around and begun to improve. We expect global GDP growth of 3.6% in 2018, up from 3.1% in 2016.

MMM is also sensitive to trends in the dollar. Looking ahead, we think the greenback is likely to decline, particularly if the Federal Reserve continues to move slowly to raise short-term rates. A stable or falling dollar would be a positive development for the Industrial sector and MMM. We expect industrial companies to benefit from a weaker dollar in 4Q17 than in 4Q16.

COMPANY DESCRIPTION

3M is a diversified Industrial company with worldwide operations organized into five segments. The company is a component of the Dow Jones Industrial Average and the S&P 500.

VALUATION

We think that MMM shares are attractively valued at current prices near $238. The shares are trading at the high end of their 52-week range of $163-$237. On a technical basis, the shares have been in a bullish trend of higher highs and higher lows that began after the stock set a double-bottom near $139 in January 2016.

To value the stock on a fundamental basis, we use peer and historical multiple comparisons, as well as a dividend discount model. MMM shares are trading at 24.5-times projected 2018 earnings, near the high end of the historical range of 15-25. On a price/sales basis, the shares are trading close to the top of the five-year range. The dividend yield of 2.1% is below the midpoint of the five-year range of 1.8%-3.0%. Compared to the peer group, 3M’s multiples are generally on the high side, which we think is reasonable given the company’s track record of consistent growth and profitability. Our comparative multiple analysis, along with our dividend discount model, points to a fair value north of $300. Blending our approaches, we arrive at a revised target price of $260.

On October 24, BUY-rated MMM closed at $234.65, up $13.10. (John Eade, 10/24/17)

ADOBE SYSTEMS INC. (NGS: ADBE, $171.58) .... BUY

ADBE: Raising target price to $195

* We think that Adobe has positioned itself at the center of the exploding market for digital video content and advertising creation and management.
* Adobe provided initial FY18 guidance on October 18. Management expects strong profit expansion next year, with non-GAAP EPS growing 30% to $5.50, well above the consensus forecast. The market rewarded ADBE shares with a 12% jump following the announcement.
* We are maintaining our FY17 EPS estimate of $4.23 and raising our FY18 forecast to $5.51 from $5.07.
* Our revised target of $195 implies a multiple of 35.4-times our FY18 EPS estimate, and a potential gain of about 14% from current levels.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY rating on Adobe Systems Inc. (NGS: ADBE) and raising our target price to $195 from $170. We think that Adobe has positioned itself at the center of the exploding market for digital video content and advertising creation and management. Adobe has a unique collection of software assets centered on its Creative Cloud digital content creation tools, which enable both professional and amateur users to create and manage digital content. With its Experience Cloud, Adobe has expanded from the initial analytics suite acquired through the Omniture merger into digital video advertising marketing and management. Adobe continues to accelerate organic product refreshes and new rollouts. It is also making small tuck-in acquisitions to bolster its software service offerings, and partnering with a host of industry leaders, from Microsoft to Accenture to Publicis Group, to drive further growth. We think that Adobe's overall consistent revenue and earnings momentum is a strong positive. We also note that management has typically underpromised and overdelivered.

RECENT DEVELOPMENTS

Adobe held an Analyst Day after the market close on October 18 in conjunction with its annual Adobe MAX user conference. Adobe reaffirmed its 4Q17 guidance and provided preliminary FY18 financial targets. Adobe projects 20% revenue growth in FY18, to $8.7 billion, close to the consensus forecast of $8.675 billion. However, it expects stronger profit expansion, with non-GAAP EPS growing 30% to $5.50, well above the consensus of $5.27. The market rewarded ADBE shares with a 12% jump — above our previous target of $170 — after the company issued its revised guidance.

Management expects the company's total addressable market to increase 29% to $83 billion in 2020 from $64 billion in 2019. Adobe has three business lines: Creative Cloud, i.e. digital content creation tools; Document Cloud (Acrobat PDF); and Experience Cloud, consisting of the Marketing, Analytics, and Advertising Clouds.

Management expects Creative Cloud and Document Cloud, collectively known as Digital Media, to grow 25% in 2020 to $29.5 billion. Digital Media's underlying growth drivers fall under three categories: core, market expansion, and value expansion. Core business growth is expected to come from:

— The continued migration of Creative Suite and Acrobat customers to subscriptions from the old perpetual license model;

— New user growth from product additions, including nascent offerings to address emerging technologies like 3D, augmented reality (AR) and virtual reality (VR);

Upselling to existing customers;

Pricing optimization designed to attract new users.

Management expects market expansion to come from photo hobbyist growth, new paid mobile users, a premium photo service, and new creative offerings. The third category, value expansion, is expected to come from Adobe Stock, training content and services, as well as from document protection and other digital document market expansion.

The Experience Cloud TAM is expected to grow 33% to $53.1 billion in 2020. Management is working to increase the sales "velocity" of the Experience Cloud business to capture the rapidly expanding market opportunity. It believes that the integrated content and data platform provides significant differentiation and a competitive advantage.

We are maintaining our FY17 EPS estimate of $4.23 and raising our FY18 forecast to $5.51 from $5.07. Our FY18 estimate is close to management's revised guidance. We think that the company's business transition continues to gain traction. Our estimates imply 35% EPS growth over the next two years. Our long-term earnings growth rate forecast is 11%.

RISKS

Adobe's technology software market is intensely competitive. The company must continually update older products and launch new products for which customer demand is uncertain. In addition, Apple's importance as a trend-setter in new markets like mobile data gives it an impact greater than its actual market share. Microsoft has also repeatedly sought to invade Adobe's market space with competitive image-processing, document-security software, and other products.

Adobe is shifting from a traditional software perpetual-license model to a cloud-based software-as-a-service subscription model. Execution risk surrounding these shifts are high, and we have seen some revenue headwinds as the company has made the transition.

It is critical for Adobe to defend its intellectual property from other claimants and potential infringers. In addition, security is always a concern with software, and the company's reputation could be damaged by software-enabled security breaches.

Because Adobe is a successful growth company, its shares tend to trade at relatively high multiples of revenue, earnings and cash flow. Expectations are high, and if the company's financial results fall short, investors could experience a significant and abrupt decline in market value. Other risks include unexpected pullbacks in software investment spending and the potentially adverse impact of foreign exchange movements.

COMPANY DESCRIPTION

Based in San Jose, California, Adobe Systems Inc. provides software for creative professionals, consumers and enterprises. Adobe has three business lines: Creative Cloud, i.e. digital content creation tools; Document Cloud (Acrobat PDF); and Experience Cloud, consisting of the Marketing, Analytics, and Advertising Clouds. The company acquired Omniture in October 2009. Adobe derives more than 40% of its revenue from overseas markets.

VALUATION

ADBE shares have risen 67% year-to-date, above the 15% return for the S&P and the 31% gain for the S&P Information Technology index.

The trailing enterprise value/EBITDA multiple of 35 is near the peer average. Adobe's forward enterprise value/ EBITDA multiple of 21.6 is 23% above the peer average, above the average premium of 20% over the past two years. We are maintaining our BUY rating on Adobe and raising our target price to $195. Our target implies a multiple of 35.4-times our FY18 EPS estimate, and a potential gain of about 14% from current levels.

On October 24, BUY-rated ADBE closed at $171.58, down $0.58. (Joseph Bonner, CFA, 10/24/17)

KB HOME (NYSE: KBH, $27.59).. HOLD

KBH: Maintaining HOLD with shares near fair value

* We are raising our FY17 EPS estimate to $1.75 per share from $1.70. Most of the $0.05 increase is a result of 3Q earnings coming in $0.04 better than we expected. We are raising our 4Q estimate by $0.01 per share based on a slightly lower estimate for the expense rate.
* We are raising our FY18 earnings estimate to $2.00 from $1.90 per share. We are expecting a greater increase in operating margin based on lower SG&A from cost control and leverage. We expect a partial offset as gross margin is likely to be pressured by higher land and labor costs.
* Based on our EPS estimates for FY17 and FY18 and our assumption that EPS will grow about 10% annually over the following three years, EPS would be approximately $2.65 in four years. If we assume that the shares trade at a terminal multiple of 12, they would be worth approximately $32 in four years. Discounted to the present at 9%, we obtain a value of about $23, which is slightly below the current price.
* KBH has a growing book value of $21.28 per share. The shares are trading at 1.3-times book value. The company's peers are also trading at approximately 1.3-times book value based on the group median. We believe that by this measure the KBH shares are trading at close to fair value.

ANALYSIS

INVESTMENT THESIS

We expect HOLD-rated KB Home (NYSE: KBH) to generate more consistent growth and profitability, fueled by gradual improvement in the U.S. housing market, increases in home deliveries, and slightly higher home pricing.

We believe that management will make progress on boosting revenue growth by emphasizing markets with favorable economic and population growth; catering to first-time buyers; boosting profit per home with greater customization, lower expenses, and better production efficiency; and improving asset efficiency by scrutinizing land investment and trying to generate higher sales per community.

A near-term constraint on EPS growth has been softer gross margins as well as by higher labor and materials costs. That said KBH is working to make operations more efficient and to reduce debt and interest expense.

Based on our valuation analysis, the shares are trading close to our fair value estimate. We remain fairly upbeat on the housing sector. We currently have BUY ratings on Toll Brothers, Lennar and D.R. Horton.

RECENT DEVELOPMENTS

On September 27, KB Home reported that net income increased by 28% to $50.2 million or $0.51 per share for the third quarter of FY17 (ended August 31, 2017).

The average analyst earnings estimate for 3Q17 was $0.46 per share, according to StreetAccount. Our estimate was $0.47. One important factor was that KBH was able to control costs, growing expenses at a slower rate than sales.

Total 3Q revenue rose 25% to $1.14 billion. Homebuilding revenues also rose 25% helped by a 19% bigger backlog at the beginning of the quarter.

The number of homes delivered rose 11% to 2,765. The average selling price rose 12% to $411,400, helped by a higher mix of sales in California, which is the company's highest priced region. Total revenue was above the StreetAccount consensus of $1.12 billion. Our estimate was $1.09 billion. Units delivered topped the consensus of 2,736, and the average selling price was slightly above the consensus of $407,000. Business was particularly strong on the West Coast and overall results benefited from slightly higher sales per community.

The leading indicators of the business remained solid in 3Q. New order value rose 15% to $1.1 billion. Units increased 4% to 2,608 homes, which was just below the StreetAccount consensus of 2,636. Orders were constrained as the community count remained flat, at 234, in 3Q. This was expected at the beginning of the quarter. One factor was that the company made significant reductions to its Southeast operations. The company expects the community count to be relatively flat in 4Q. KBH invested $417 million in land in 3Q17.

The cancellation rate improved by 400 basis points from the prior year to 25%.

The backlog rose 14% year-over-year to $2.1 billion, with units in backlog up 4%, to 5,455 homes. Backlog dollars were slightly above consensus, while backlog units were slightly below the StreetAccount consensus.

The company's homebuilding operating income increased 49%, to $76.7 million. The StreetAccount consensus was $69.5 million.

Excluding the amortization of previously capitalized interest and inventory-related charges, the adjusted gross margin improved by 50 basis points to 21.7%. Reported gross margin was 16.2%, which was just below the StreetAccount consensus of 16.5%.

SG&A decreased by 120 basis points to 9.6% of housing revenue. The StreetAccount consensus was 10%. SG&A expenses were up $11 million on a $230 million increase in housing revenue.

Pretax income increased 48% from the prior year to $79 million. Our estimate was $73 million. The company's 3Q tax rate was 36.6%.

EARNINGS & GROWTH ANALYSIS

We are raising our FY17 EPS estimate to $1.75 per share from $1.70. Most of the $0.05 increase is a result of 3Q earnings coming in $0.04 better than we expected. We are raising our 4Q estimate by $0.01 per share based on a slightly lower estimate for the expense rate.

Our revised estimate of full-year homebuilding revenue is $4.31 billion, up from $4.25 billion previously. We now expect about 20% growth for the year rather than 19% growth.

Management expects the average selling price in 4Q to be $425,000-$430,000 and the community count to be flat at about 238 communities. The company could see a sales benefit from a growing proportion of communities on the West Coast where the performance has been strong. The average analyst estimate is now approximately $1.76 per share for the year.

We are raising our FY18 earnings estimate to $2.00 from $1.90 per share. We are expecting a greater increase in operating margin based on lower SG&A from cost control and leverage. We expect a partial offset as gross margin is likely to be pressured by higher land and labor costs.

We expect KBH to grow EPS at a compound annual rate of 10% over the next five years. This assumes a continued recovery in the housing market, easing credit conditions for first-time buyers, and margin expansion on higher sales volume. The company's longer-term objectives are to raise sales above $5 billion in FY19, which represents a compound annual growth rate of about 11.5% from $3.6 billion in FY15. Attaining this requires a sales increase of about 3.6% from our FY18 estimate. KBH also aims to raise operating margin to 8%-9% from about 6% last year. Among other goals, the company wants to boost return on capital into double digits. Challenges include finding lots, raising profitability with the likelihood of higher land prices and lower margins on smaller or entry-level homes. The company must also deal with labor shortages of carpenters and masons which could raise some costs. An offset should be expense leverage on higher sales and more productive communities.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on KBH is Medium. Business is improving; however, this improvement must continue for KBH to maintain its financial strength rank relative to peers with stronger metrics. The company ended 3Q17 with $494 million in cash and equivalents in the homebuilding segment, up from $334 million a year earlier.

KBH has made $1.1 billion of land and development investments in the first three quarters of FY17. The total dollar value of owned and optioned land increased by 35% to $2.3 billion in FY13, rose 39% to $3.2 billion in FY14, and climbed a more modest 3% to $3.3 billion in FY15. The dollar value was $3.4 billion at the end of FY16, and at $3.5 billion at the end of 3Q17. The lot count was 45,624 at the end of 3Q17, with 78% owned and 22% optioned.

Total debt from mortgages and notes payable was $2.50 billion at the end of 3Q17, which was down slightly from $2.67 billion the prior-year. Debt/capital was 58% at the end of 3Q, down from 61% a year earlier. This ratio remains above the peer average of 31%. As discussed in previous notes, equity rose when the company reversed its $825 million valuation allowance against tax-deferred assets. The company's goal is to further reduce debt/cap to the 40%-50% range and we expect KBH to reach the high end of this range at the end of FY17.

Operating income was approximately 2-times interest expense in FY13 and increased to nearly 10-times in FY14, stayed solid at 8-times in 2015 and rose to 27-times in FY16.

In March 2010, KB Home voluntarily terminated its $200 million credit facility and began issuing letters of credit against cash deposit collateral at a variety of financial institutions. In FY12, it was able to refinance $585 million in debt coming due, pushing back maturities significantly. In FY13, it raised $333 million in an offering of convertible senior notes, completed an equity offering, and issued debt due in 2021. In March 2013, KBH entered into a new $200 million credit facility. In 3Q15, it raised the capacity of the revolver to $275 million. In July of 2017 the company raised the capacity to $500 million and extended the maturity to 2021 from 2019. There was no borrowing under the revolver at the end of 3Q. The available capacity on the revolver was about $465 million.

In February 2015, the company issued $250 million of 7.625% bonds due 2023. KBH's largest debt maturity is $450 million in 2021. Subsequent to the end of the quarter the company repaid about $165 million of debt that was due in in September of 2017. The company had investments in joint ventures with a balance sheet value of $64 million at the end of FY16, $72 million at the end of FY15, $79 million at the end of FY14 and $130 million at the end of FY13. The investment was $64.5 million at the end of 3Q17.

We do not expect significant buyback activity in the near term, as we believe the company is more likely to acquire land if it wishes to deploy cash. That said, KBH did repurchase almost 8.4 million shares under a 10 million share program that was established in January of 2016. There was no buyback activity in the first three quarters of FY17. There was a remaining authorization to purchase 1.6 million shares at the end of 3Q17.

After a weak 1Q12, KBH slashed its annual dividend by 60% to $0.10. KBH paid full-year dividends totaling $0.10 in FY13, FY14, FY15 and FY16. Our dividend estimate remains at $0.10 for FY17. Our FY18 estimate is also $0.10.

The company's long-term debt is rated B1 by Moody's, and B+ by Standard & Poor's. S&P has a positive outlook. Moody's now has a stable outlook. Any reduction in ratings could constrain the company's ability to borrow and finance future growth.

Credit default spreads on KBH's debt are now narrower than those for Kohl's and Macy's which we assess at Medium (narrower spreads mean less risk). KBH's spreads are wider than those of MDC Holdings, which we assess at Medium. Spreads on KBH are significantly wider than Toll Brothers, which we also assess as Medium. KBH is improving its profitability and its leverage ratios have improved, particularly with the reversal of the deferred tax valuation allowance. That said, we need to see continuing improvement from KBH if we are going to maintain our financial strength assessment on a relative basis. It is interesting that default spreads are now suggesting that builders are becoming less risky than department stores.

MANAGEMENT & RISKS

Jeff Mezger has been CEO of KB Home since 2006, and previously served as chief operating officer. He has been at the company for 20 years. Jeff Kaminski has been CFO since 2010 and previously held the same role at Federal-Mogul Corporation.

Mr. Mezger unfortunately made the mainstream news when a recording emerged of what the Wall Street Journal described as an "expletive-laced tirade replete with sexist and antigay language," after his neighbor, the comedian Kathy Griffin or her boyfriend called the police to complain about noise coming from Mr. Mezger's property in the Bel Air neighborhood of Los Angeles. The company's board said, in an SEC filing, that his behavior during the incident was unacceptable and reflected negatively on the company. The board cut Mr. Mezger's bonus by 25% and said that he would be fired if there was another such outburst. In the 3Q earnings call Mr. Mezger said that he regretted the incident immediately and apologized for it sincerely.

Housing trends have shown improvement and affordability remains favorable, though home prices have increased. While we expect the housing recovery to continue, helped by an improving job market and still-reasonable interest rates, there are risks: underwriting standards are easing very slowly, and household formation has been well below average for young adults. Labor and materials costs could be an ongoing constraint on profitability. That said, KBH has seen stability in markets that are close to employment centers and have more affluent populations. An ongoing challenge is the limited supply of good building lots in some markets. Borrowing conditions are important because about half of KBH's customers are first-time buyers, and unlike Toll Brothers, nearly all of KBH's buyers finance the purchase of their home.

The improvement in end-market demand has caused builders that managed lean inventories to lag the recovery, while others have had the necessary land supply to ride the wave. The company ended FY13 with approximately $2.3 billion of owned and optioned land, up 35% from the prior-year period. KBH had inventory of approximately $3.4 billion at the end of 4Q16. Management's aim is to control enough land to meet their production goals for the next 3-5 years. Based on the pace of deliveries in FY16, the lots controlled by the company would last about 4.5 years.

KBH is subject to legal and warranty claims as discussed in the annual report.

COMPANY DESCRIPTION

KB Home, headquartered in Los Angeles, is one of America's largest homebuilders, with domestic operations in California, Arizona, Nevada, Colorado, Texas, Florida, and North Carolina. In FY16, the company delivered 9,829 homes, generating revenue of $3.6 billion. The West Coast segment represents almost half of homebuilding revenue, with just 29% of homes delivered helped by high home prices in California. The company targets the lower-middle range of the market, including first-time buyers, but has also expanded into higher-priced markets. KBH's average selling price was $364 thousand in 2016, up 2.50% from 2015.

VALUATION

KBH shares have risen approximately 80% over the last 12 months. The shares are trading at 15.6-times our FY17 estimate and 13.7-times our FY18 estimate. With the Great Recession still in memory and a strong housing recovery still underway, historical comparisons are challenging. As such, we value the shares using a simple discounted earnings model and based on peer comparisons with earnings and book value.

Based on our EPS estimates for FY17 and FY18 and our assumption that EPS will grow about 10% annually over the following three years, EPS would be approximately $2.65 in four years. If we assume that the shares trade at a terminal multiple of 12, they would be worth approximately $32 in four years. We arrived at the terminal value in two ways. We used a dividend discount model to generate estimates of the terminal stock value and terminal P/E multiple, and we looked at the median multiple for the admittedly volatile S&P 500 Homebuilding Index over the last 30 years. That multiple is approximately 12, and we are currently modeling KBH's terminal multiple at parity with the index. If we discount the projected $32 share price in four years to the present at 9%, which is the standard rate we use for consumer stocks, we obtain a value of about $23, which is slightly below the current price.

Looking solely at P/E multiples for next year, we believe that the shares are fairly-to-fully valued at the peer average. KBH is trading at 13-times the consensus estimate for 2018, versus the peer average of 12. We believe these multiples reflect the potential for recovery-driven earnings over the next few years.

KBH has a growing book value of $21.28 per share. The shares are trading at 1.3-times book value. The company's peers are also trading at approximately 1.3-times book value based on the group median. We believe that the shares are trading at close to fair value. Our rating on KBH remains HOLD.

On October 24, HOLD-rated KBH closed at $27.59, up $0.66. (Christopher Graja, CFA, 10/24/17)

PUBLIC SERVICE ENTERPRISE GROUP INC. (NYSE: PEG, $49.08) .... BUY

PEG: Raising target by $5 to $56

* We expect above-average growth in PEG's rate base from infrastructure investments, as well as higher profitability in its nonregulated operations. In addition, we look for annual dividend growth of 4.0%-5.0% over the next several years. The shares offer a solid dividend yield of about 3.5%.
* We view the company's increased spending on electric transmission and gas pipeline projects as a strong plus, as these facilities are more likely to provide higher returns on equity than those earned on distribution and generation assets.
* PEG will report 3Q17 results on November 1. Management projects 2017 operating earnings of $2.80-$3.00 per share. Our EPS estimates are $2.91 for 2017 and $2.98 for 2018.
* PEG trades at 16.4-times our 2018 EPS estimate, below the average multiple for electric and gas utilities with both regulated and nonregulated assets.

ANALYSIS

INVESTMENT THESIS

We are raising our target price on BUY-rated Public Service Enterprise Group Inc. (NYSE: PEG) by $5 to $56, based on the company's growing network of transmission assets, which have the potential to earn a higher return on equity than utilities with generation and distribution assets, and its well-managed regulated utility subsidiary, Public Service Electric & Gas Co. (PSE&G).

We view the company's increased spending on electric transmission and gas pipeline projects as a strong plus, as these facilities are more likely to provide higher returns on equity than those earned on distribution and generation assets.

We expect above-average growth in the company's rate base from infrastructure investments, as well as higher profitability in the company's nonregulated operations. In addition, we continue to expect annual dividend growth of 4.0%-5.0% over the next several years. The shares currently offer a solid dividend yield of about 3.5%.

Utilities as a group are heavily debt-financed and aggregate interest charges are likely to rise. In addition, in a rising interest rate environment, equity investors seeking income more often than not move away from utility industry shares and turn to the bond market, as fixed-income rates begin to rise. Even so, we think Public Service, with its strong finances and solid management execution, will outperform other utilities in a rising interest rate environment.

The company should continue to benefit from strong cost controls, solid cash flow from operations, a strong management team, and what we view as a favorable regulatory environment at both the state and federal levels. In addition, our positive assessment reflects the company's efficiently operated nuclear generation units, focus on balance sheet improvement, and expanding economic activity in its service area. We believe that the company's core business strategy complements its well-balanced asset portfolio, and that its regulated electric and gas business is well positioned for growth beyond 2017.

RECENT DEVELOPMENTS

Over the past three months, PEG shares have advanced 11%, compared to an increase of 4% for the S&P 500. Over the past 52 weeks, the shares have risen 20%, in line with the index. The five-year track record shows an increase of 58% for PEG, versus 81% for the S&P 500. The beta on PEG shares is 0.21.

EARNINGS & GROWTH ANALYSIS

Management's 2017 operating earnings guidance is $2.80-$3.00 per share. The company will report 3Q17 results on November 1.

Our EPS estimates are $2.91 for 2017 and $2.98 for 2018. Although PEG is a well-managed utility, we expect it to face some pressure from rising depreciation and higher property taxes related to its infrastructure buildout program, as well as from customer conservation efforts.

Our estimates take into account the continued expansion of energy assets under the company's infrastructure improvement program, as well as its favorable natural gas supply position and buildup of solar energy assets. PSEG is also beginning to benefit from a turnaround in nonregulated wholesale power prices, as well as from lower supply costs.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Public Service Enterprise is Medium-High, the second-highest rank on our five-point scale. The company's bond ratings are investment grade. Public Service remains focused on balance sheet improvement, growth in cash flow and strong cost controls. While total debt has increased as a result of its infrastructure buildout program, the overall cost of financing has declined due to refinancing activity and lower interest rates. The company ended 2Q17 with a relatively low long-term debt/capital ratio of 49%, well below the sector average of 55%. EBITDA covered interest expense by a factor of 6.7 in 2Q17, slightly below the industry average, which is closer to 6.9. The 2Q17 profit margin was 14.9%, compared to 14.1% in 2Q16. Operating cash flow rose to $1.197 billion in 2Q17 from $1.115 billion in 2Q16. Second-quarter operating cash flow was 104% of cash used in investing activities.

Increasing shareholder value remains a priority, and the company has paid dividends without interruption since 1907. The annualized dividend is currently $1.72 per share, for a yield of about 3.5%. Our dividend estimates are $1.72 for 2017 and $1.78 for 2018. We expect meaningful dividend increases over the next 3-4 years.

MANAGEMENT & RISKS

Ralph Izzo was elected chairman and CEO of Public Service Enterprise Group in April 2007. He became the company's president and chief operating officer and a member of the board of directors in October 2006. He previously served as president and chief operating officer of PSE&G.

On September 23, 2015, Daniel J. Cregg, formerly VP of Finance for PSE&G, was named executive vice president and CFO. During his 24-year career with the company, Mr. Cregg has held senior financial positions at both PSE&G and PSEG Power.

Overall, we believe that Public Service Enterprise is committed to electric and gas service expansion strategies in its regulated service territory and that it is keeping O&M expenses in check. In addition, we think the company's platform for growth is solid, and we are confident in management's ability to provide shareholders with increased value over the long term.

The company's regulated utility operations are subject to cooler-than-normal conditions during the summer air-conditioning season, and the gas distribution business faces the possibility of warmer-than-normal temperatures during the winter heating season. Although utility regulation in New Jersey is generally balanced, there is always the possibility that regulators will lower the company's allowed return on common equity. The company's earnings could also come under pressure in the event of a downturn in the U.S. economy.

COMPANY DESCRIPTION

Public Service Enterprise Group is a combination electric and gas utility holding company, with regulated operations serving a large part of New Jersey, and nonregulated operations serving electricity markets primarily in the Mid-Atlantic and Northeast. It has two primary wholly owned subsidiaries: PSE&G (a regulated utility), and nonregulated PSEG Power (nuclear, solar and fossil-fuel-powered electric generating operations). At the end of 2016, the company operated a portfolio of 13,850 megawatts of installed generating capacity.

INDUSTRY

Our rating on the Utility sector is Under-Weight. The sector outperformed the S&P 500 in 2016, with a gain of 12.2%, after underperforming in 2015, with a loss of 8.4%. It is underperforming thus far in 2017, with a gain of 7.8%.

The sector accounts for 3.2% of the S&P 500. Over the past five years, the weighting has ranged from 2.0% to 4.0%. We think the sector should account for at most 2%-3% of diversified portfolios. The sector includes the electric, gas and water utility industries.

By our calculations (using 2018 EPS), the sector price/earnings multiple is 17.0, above the market average of 16.6. Earnings are expected to rise 6.4% in 2018 and 6.9% in 2017 after rising 21.5% in 2016 and falling 14.9% in 2015. The sector's debt-to-cap ratio is about 55%, above the market average. This represents a risk, given the current state of the credit markets, particularly if corporate bond rates rise. The sector does offer an attractive dividend yield of about 3.4%.

VALUATION

PEG trades at 16.4-times our 2018 EPS estimate, below the average multiple for electric and gas utilities with both regulated and nonregulated assets. The stock also trades at a discount to peers based on price/cash flow and price/book.

Other favorable factors are the company's experienced management team, strong operating efficiencies, limited risk profile, solid cost controls, and generally positive relations with regulators. The company also has a strong balance sheet and continues to add new customers in an improving service area economy. Overall, we believe that the company is committed to optimizing the value of its regulated and nonregulated assets.

We believe that PSEG has the potential to generate total annual returns for shareholders of 5%-6% over the next four to five years. Our revised target price of $56, along with the dividend, implies a potential total return of about 17% from current levels.

On October 24, BUY-rated PEG closed at $49.08, up $0.10. (Gary Hovis, 10/24/17)