WILSONS

Earnings in a Post-COVID World

Our weekly view on Australian equities.

15 June 2022

Normalising after an Unprecedented Shock

During the COVID-19 pandemic the economy suffered an unprecedented shock, resulting in large and unexpected changes in household spending patterns.

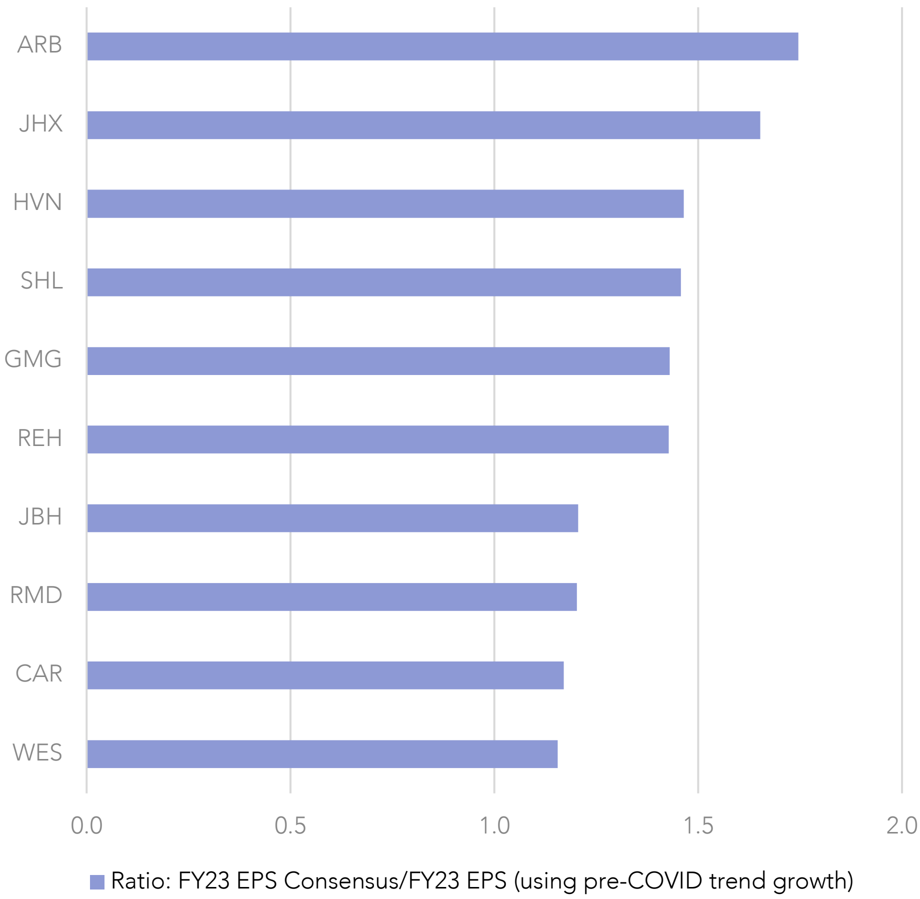
Restrictions on household activity limited opportunities to consume services, and aided by unprecedented fiscal stimulus, consumers switched to purchasing more goods.

Some ASX 100 stocks have experienced supernormal profits over the past 2 years because of the shift in spending toward furniture, electronics and other household goods, especially during March 2020 and the NSW/VIC lockdowns in the 2021 winter (impacting FY22E).

Household spending looks to be normalising as consumers spend more on travel, entertainment and services while spending less on goods. This should normalise further as we enter FY23.

This raises the question of how the earning profiles for pandemic beneficiaries should look in a post-pandemic world.

Figure 1: ASX 100 stocks where EPS growth has accelerated over the pandemic. Consensus FY23 EPS estimates could be too optimistic relative to pre-COVID trend growth



Source: Refinitiv, Wilsons.

Optimistic FY23/24 earnings

The challenge for analysts is forecasting earnings in a post-COVID world, and we believe this is fraught with risk - most likely downside risk - particularly as we enter a slower growth phase in the cycle.

To identify anomalies in earnings levels we analysed the earnings profiles of ASX 100 companies before and after COVID. Consensus for some of these stocks has extrapolated some of this over-earning during COVID into the future and now earnings look too optimistic.

We believe these earnings levels are unlikely to be sustainable into the future and these stocks face the risk of earnings downgrades.

Shifts in Spending may Persist

There are a few stocks that have experienced a significant jump in earnings from COVID, but rather than a one-off event this has been a more permanent shift in demand.

Cloud-related stocks and some e-commerce stocks should continue to enjoy elevated earnings as consumers have changed their habits during COVID, such as working from home a couple of days a week or shopping more online. Examples of stocks like this include NextDC (NXT) and Goodman Group (GMG).

In a post-lockdown world, investors might observe a structural change in household spending habits. Nonetheless, some of these stocks still appear to have levels of consensus EPS that are still too high.

Pandemic Value Traps

The price-to-earnings (PE) multiples of some of these pandemic beneficiaries may look cheap, but we think this could be a value trap.

We believe it is worth looking at stock valuations on earnings excluding the one-off COVID uplift, rather than using a potentially inflated consensus earnings per share (EPS).

If we use trend earnings growth pre-COVID to forecast an FY23 EPS, the stocks do not look cheap and actually could be substantially above their average pre-COVID forward PE multiples.

Figure 2: Using pre-COVID trend growth to forecast FY23E EPS indicates some stocks still look expensive

Company Name	Ticker	Price Pre COVID (31/12/2019)	Price Last Close	FY23 EPS (Consensus)	FY23 EPS (Using pre-COVID trend EPS Growth)	FY23 PE (Consensus)	FY23 PE (Using pre-COVID trend FY23 EPS)	Average 12mth fwd PE pre COVID (2016-2019)
ARB	ARB	18.8	29.8	1.49	0.86	20.0x	34.9x	23.9x
Harvey Norman	HVN	4.0	4.2	0.42	0.29	9.9x	14.6x	12.9x
Reece	REH	11.4	14.4	0.66	0.46	21.8x	31.2x	20.5x
Sonic Healthcare	SHL	28.8	34.8	1.78	1.22	19.6x	28.5x	19.5x
Resmed	RMD	21.9	29.7	0.94	0.78	31.6x	38.0x	25.8x
James Hardie	JHX	27.4	34.9	2.40	1.45	14.5x	24.0x	20.7x
JB Hi-Fi	JBH	37.7	43.7	3.67	2.77	11.9x	15.1x	13.1x
Goodman Group	GMG	13.4	19.4	0.93	0.65	20.8x	29.7x	19.1x
Carsales.Com	CAR	16.3	19.2	0.76	0.65	25.1x	29.4x	23.0x
Wesfarmers	WES	39.9	43.7	2.11	1.83	20.7x	23.9x	18.1x

Source: Refinitiv, Wilsons.

Profit Margins Harder to Maintain

In general, most of these COVID beneficiaries have seen relatively high margin expansion during the past 2 years. For many of these companies this was due to cashed-up consumers buying high-margin items and/or goods retailers selling their products without discounting (something they do in a typical fiscal year, EOFY sales etc).

We think these margins will be hard to maintain as we see a recalibration of spending back to services and away from goods, lowering the demand for these companies' products and necessitating higher discounts – especially as some inventories now seem relatively high.

As we enter the mid-late cycle these margins may be harder to maintain as inflation bites and consumers have less money to spend in a world of tightening monetary policy and lower government stimulus.

An exception here is James Hardie (JHX). We believe the margin expansion seen over COVID is still sustainable in a post-COVID world. It is worth noting that JHX was expanding margins before COVID, and the CEO at the time had explicitly stated margin expansion was key to providing value to shareholders, which was being executed on.

Figure 3: Profit margins have expanded for most of these stocks

Company Name	Ticker	EBITDA Margin (FY2019)	EBITDA Margin (FY2023E)	EBITDA Margin Change	Net Income Margin (FY2019)	Net Income Margin (FY2023E)	Net Income Margin Change
ARB	ARB	21%	26%	1.3x	13%	16%	1.3x
Harvey Norman	HVN	19%	25%	1.3x	10%	13%	1.2x
Reece	REH	9%	11%	1.2x	4%	5%	1.3x
Sonic Healthcare	SHL	17%	23%	1.4x	9%	10%	1.2x
Resmed	RMD	30%	35%	1.1x	20%	24%	1.2x
James Hardie	JHX	21%	29%	1.4x	12%	18%	1.5x
JB Hi-Fi	JBH	6%	9%	1.5x	4%	5%	1.4x
Carsales.Com	CAR	50%	56%	1.1x	31%	40%	1.3x
Wesfarmers	WES	13%	14%	1.1x	7%	6%	0.9x

Note: GMG not included in this table as margins not as relevant for REITs.
Source: Refinitiv, Wilsons.

Case Study – JB Hi-Fi (JBH)

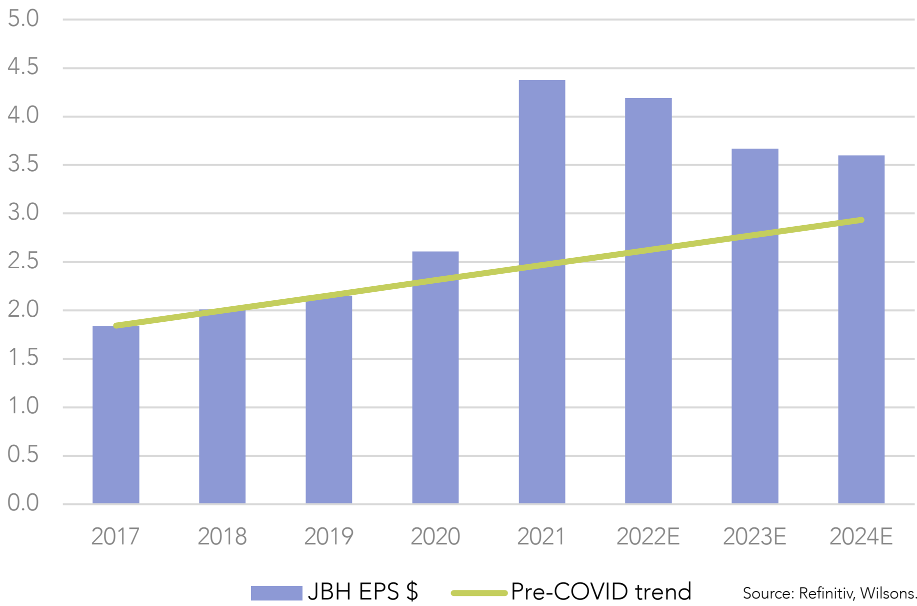
JB Hi-FI (JBH) is a case in point. Pre-COVID, the company acquired The Good Guys in 2016 and saw a steady increase in EPS from 2017-2019, growing at ~8% per annum. Extrapolating this "normalised" growth to FY24E gives an EPS lower than consensus, at around $3. Consensus is forecasting an EPS of ~$3.50.

We believe this is too high and still accounts for the one-off COVID spending that is already fading. This leaves room for earnings downgrades for FY23 and FY24.

JBH's price is now very close to its pre-COVID levels. However, PE multiples for stocks like JBH were elevated running into 2020. JBH PE multiple increased from ~10x in January 2019 to ~18x by February 2020. We think in a world of rising interest rates and potentially slower consumption, a PE of 10-12x is more aligned with the macro backdrop for JBH.

While the current PE of 11x is consistent with our expectations, the "E" in the PE still looks overstated. Using a FY23 EPS of $2.8 (comparable with pre-COVID trend growth) the PE would be ~15x, well above our expectations for the valuation.

Figure 4: JBH consensus EPS looks too high relative to pre-COVID trend growth



Source: Refinitiv, Wilsons.

Figure 5: JBH looks cheap using consensus EPS – but not if consensus EPS is overstated

Source: Refinitiv, Wilsons.

Risks to the Downside Remain

It is worth noting that while this is a relatively simplistic analysis and we are not categorically concluding the stocks highlighted in this note are overvalued, we believe the risk remains to the downside for a large portion of these stocks. However, every case must be considered on its own merit.

There is still uncertainty regarding the spending habits of households in a post-COVID world, so investors should be cautious about investing in these stocks until we get more clarity.

Focus List Holdings

We have exposure to GMG and JHX in the Focus List. Although these stocks have seen a jump in earnings during the pandemic, we believe these are structural stories. GMG has seen a pull-forward in earnings from the pandemic as the world has accelerated its shift to e-commerce and demand for industrial property.

JHX has also seen a boost in demand from the lower interest environment during the pandemic. However, we still believe there is a structural supply deficit in the US housing market, housing stock is still very low, and house prices are still rising. We recently trimmed our weight in JHX to 3% as we believe the slowdown in the cycle will be a dampener to demand, but still like the story long-term. However, we are monitoring the risks identified in this analysis.

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