WILSONS

Australian Equities: A Reflection of Style

Our monthly view on Australian equities.

15 October 2020

Tilting the Focus List Towards Economic Recovery

The Wilsons Australian Equity Focus List is a weighted list of companies following a quality/growth investment theme. We believe these two style traits in Australian equities can outperform over the medium/long-term, given the weight of evidence that investors reward return on capital (quality) and earnings (growth).

Here we dig deeper into the five 'style buckets' within the Focus List and the characteristics and themes the Focus List is exposed to.

We have made a number of changes to the Focus List as we tilt further towards economic recovery.

Discretionary retailer Super Retail (SUL) has been added to the Focus List in anticipation of further earnings momentum into 2021. We have neutralised our underweight banking exposure, adding to both Commonwealth Bank (CBA) and ANZ Group (ANZ). The case for continued underperformance has diminished.

We reduce our defensive exposure by removing Amcor (AMC), following a period of strong share price performance. Link Group (LNK) has been removed following takeover interest and strong share price performance.

We recently upgraded our view on Australian equities with the release of our Q4 Asset Allocation Strategy report. This follows a period of Australian equities underperformance versus the rest of the world. We have also become more confident around the shape of the economic recovery following last week's Federal Budget. Combined with measures already in place, we believe the new stimulus announcements will help stimulate and support the recovery in earnings within the domestic market.

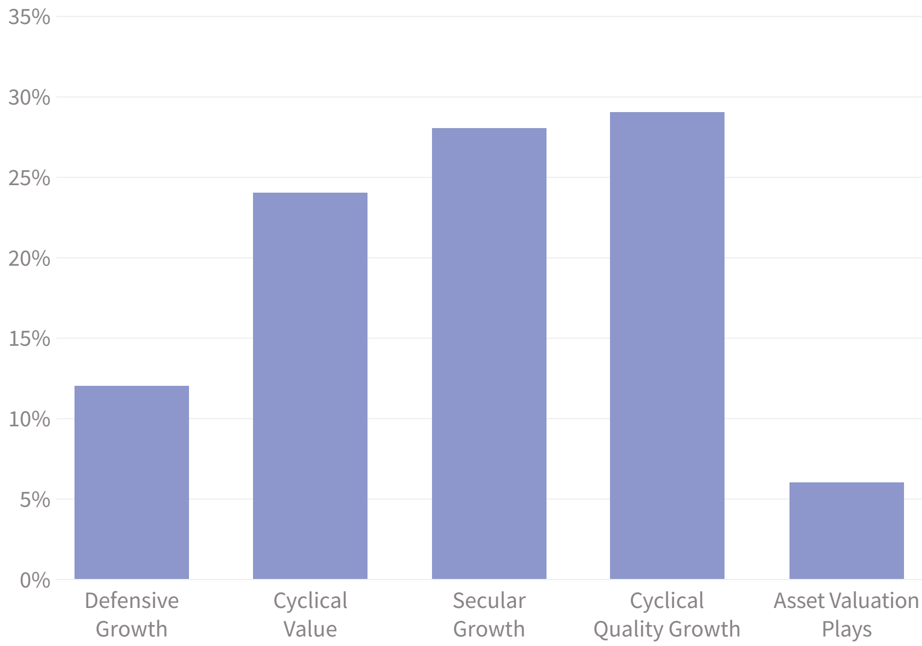
Read our Q4 Asset Allocation Strategy report.

Five Styles of the Focus List

The Focus List is built around 5 'style buckets' that each company is classified into and that describe the attributes we are looking for in each company. Taken together, these styles give the Focus List the quality and growth characteristics we are looking for.

1. Defensive Growth
2. Cyclical Value
3. Cyclical Quality Growth
4. Secular Growth
5. Asset Valuation Plays

Exhibit 1: Five styles of the Australian Equity Focus List (% Weight)



Source: Refinitiv, Wilsons.

1. Secular Growth

Companies in this category typically have well above market levels of forecast earnings growth, large addressable markets and the prospect of multiple years of above market growth.

Exhibit 2 shows the implied long-term earnings per share (EPS) growth rates using consensus forecasts. The relative growth rates between the styles are more important than the absolute level of implied growth.

Almost 30% of the Focus List is exposed to secular growth including A2 Milk (A2M), Appen (APX), CSL (CSL), Goodman Group (GMG), ResMed (RMD) and Xero (XRO). The Focus List is typically overweight secular growth quality/growth focus.

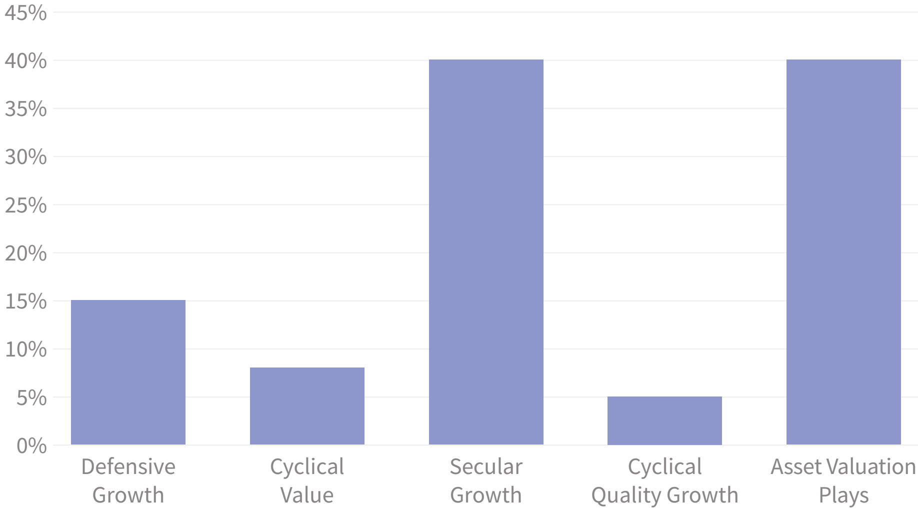
Secular growth companies can have "growth bumps" along the way that can cause drawdowns in share prices. However, volatility is normal, and if the underlying investment thesis remains intact investors should continue to hold secular growth companies.

Amazon (AMZN.US), the best known secular growth company, has seen 18 separate share price drawdowns of >30% from its IPO price of $US18 in its rise to ~$US3,400.

A2M downgraded earnings in mid-September, with the stock falling ~30% below its August high. The reason for the earnings downgrade is likely to be transitory, with the megatrend of high-quality, safe milk products into China and the rest of the world being a more powerful and enduring thematic.

In the past five years, A2M has had three separate drawdowns of ~30%. Despite this, the stock has returned >20x over the past five years. We currently hold a 2% weighting to A2M.

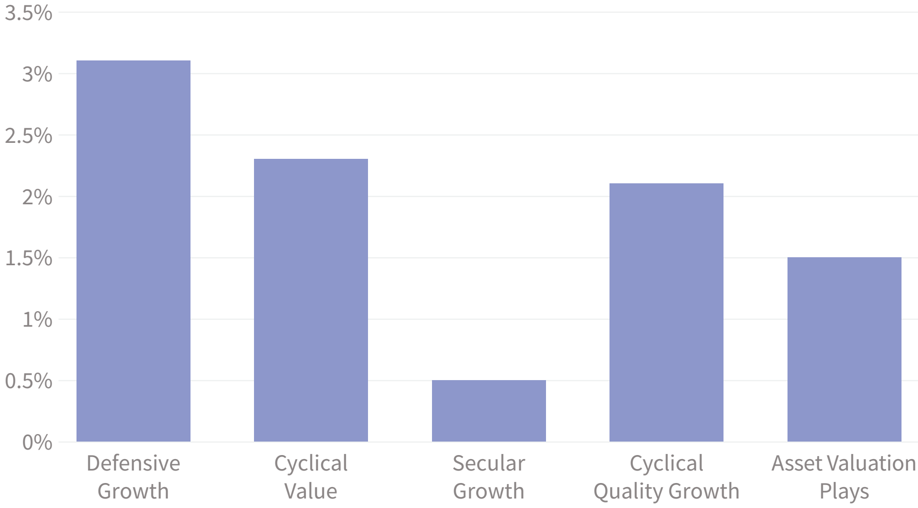
Exhibit 2: Secular growth companies: high long-term implied EPS growth rates



Long-term growth rate

Source: Refinitiv, Wilsons.

Exhibit 3: Defensive growth companies: highest dividend yield in the Focus List



Div Yield (FY1)

Source: Refinitiv, Wilsons.

2. Defensive Growth

Defensive growth companies can grow earnings around GDP levels, and with little revenue growth variance across economic cycles.

Typically companies with this style trait have strong industry positions return on capital, while acquisitions often support earnings growth. Strong cash flows can be directed at dividends or capital management initiatives. At present, this style is offering the highest dividend yield within the Focus List.

We think of defensive growth companies as somewhat of a backstop for the Focus List. When investors worry about future economic growth rates, defensive growth companies should perform well. Due to our growing confidence in an economic recovery, we have reduced our exposure to defensive growth with the removal of Amcor (AMC).

3. Cyclical Quality Growth

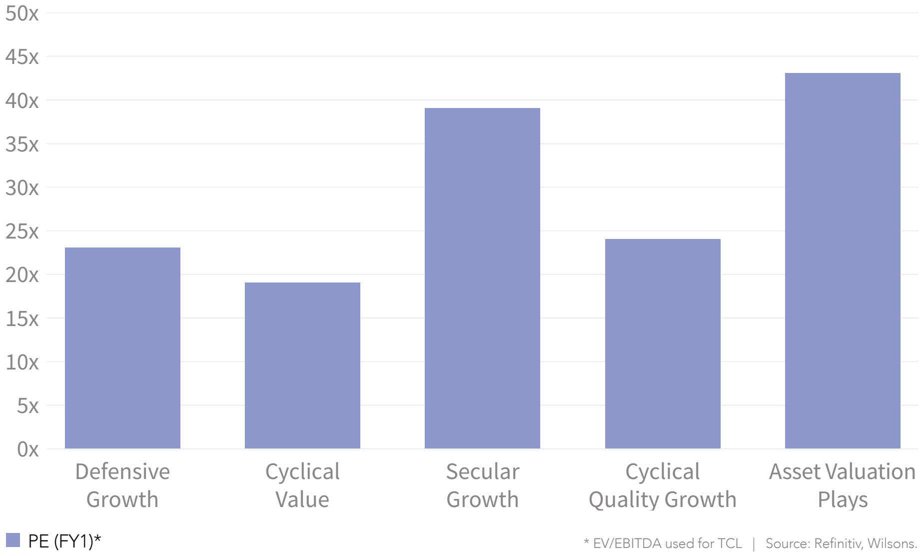
Earnings growth can be persistent in some stocks over multiple years – particularly when powered by secular growth drivers. Cyclical quality growth companies do not have the same persistent growth attributes, often due to their size (the large banks, for example), or simply because they have more economically sensitive earnings bases.

This creates opportunities for investors, particularly as different parts of the economy grow at different rates. As a result, earnings can accelerate for periods of time much faster than that of the market, leading, in some cases, to dramatic re-rating of share prices.

Commonwealth Bank (CBA) is an example of cyclical quality growth. We differentiate CBA versus other major banks because of its higher return on equity (ROE - Quality), which we believe is a structural feature of CBA. A wall of negative news flow over recent years has led to CBA's depressed share price and more than 5 years of underperformance, though we sense risks are now more skewed to the upside.

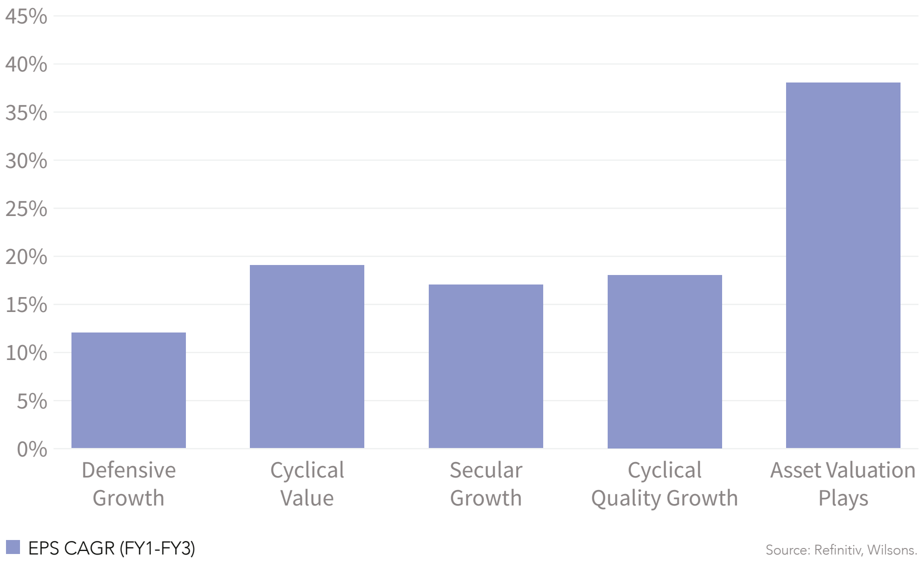
Softening regulatory settings, royal commission adjustments, early signs of acceleration in credit growth, uncertainties around bad debt profile and long-dated structural threats hold us back from being overtly bullish, though it is not difficult to see how share prices for the banks could re-rate significantly as the economic recovery takes hold over 2021/22.

Exhibit 4: PER Ratio* of Styles – trough earnings for cyclical sectors inflate the PER



* EV/EBITDA used for TCL | Source: Refinitiv, Wilsons.

Exhibit 5: 3-year forecast EPS compound annual growth rate



Source: Refinitiv, Wilsons.

4. Cyclical Value

Cyclical value companies offer earnings improvement potential, but do not have the same through-cycle returns on equity as cyclical quality growth companies. At the bottom of the earnings cycle, cyclical value companies can be generating return on capital below their cost of capital.

For a quality/growth Focus List, we are relatively overweight cyclical value at a 25% weighting. This is primarily driven by our view around an emerging post-COVID-19 economic recovery. For many companies sensitive to the economy, we believe this should see earnings improve in the coming years.

It is rare that cyclical value companies should have near-term earnings growth greater than the secular growth style. This is simply a reflection of earnings recovery potential in cyclical value names, at a point in the economic cycle where earnings are depressed.

Santos (STO) for oil price recovery exposure and Oz Minerals (OZL) for copper price recovery exposure, are types of cyclical value companies currently in the Focus List.

We have increased our exposure to this style, lifting ANZ Group (ANZ) and adding Super Retail (SUL) for the expected boost to domestic consumption as Australians holiday at home. Both companies should have improved operating conditions as the recovery takes hold. Other names in this style include Reliance Worldwide (RWC) and Seven Group Holdings (SVW).

5. Asset Valuation Plays

Stocks in this camp are our most value-oriented exposures. Investors can often ignore aspects of a company, creating fundamental mispricing opportunities.

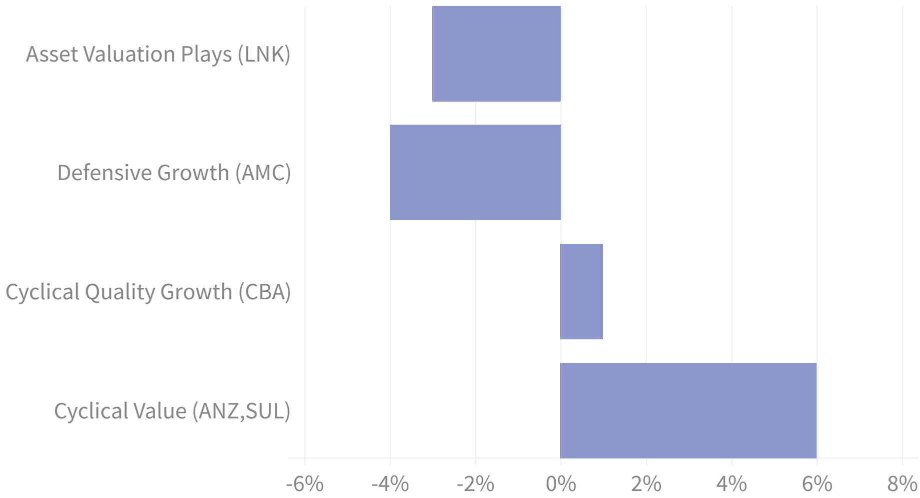
Like any value-based style, value can sometimes remain apparent for longer than many investors can remain patient.

A control mechanism within our investment approach is that asset valuation plays must have an identified catalyst to release value. More weight is given to those companies where the catalyst is an internally driven event (change of management, non-core asset sale), not an external event the company has no control over (regulatory outcome, change in commodity price).

News Corp (NWS) represents our largest holding in this category at present. The company has sold non-core assets and refocused investor attention on the growth assets within the NWS portfolio and the stock has performed strongly as a result.

We believe the major asset play within NWS over the short to medium-term is the management-led separation of real estate properties from the media assets. We believe this could unlock substantial value for shareholders.

Exhibit 6: Focus List style change – further tilting towards recovery



Source: Wilsons.

Australian Equities Focus List Changes

A good way to picture the Focus List changes this month is to look at them through the same style framework we have outlined above. The tilt further towards economic recovery can be seen by adding to cyclical quality growth and cyclical value, at the expense of defensive growth.

Super Retail Group (SUL)

Five reasons to own SUL:

1. Discretionary retailers focused on domestic outdoors/lifestyle activities are seeing buoyant conditions as consumers emerge from lockdowns and plan for summer activities within Australia. With international borders closed for the foreseeable future and pent up domestic demand – we think earnings risks remain to the upside.

2. ARB Corporation (ARB) is seeing elevated consumer demand for automotive lifestyle accessories. Our analysts think domestic sales growth will jump from <2% to >15% 1H21 versus the previous corresponding period, remaining elevated into 2H21. Bapcor's (BAP) trading update this week suggested an acceleration in sales growth from ~8% May-July to >15% in Aug-Oct. Our unlisted contacts in the outdoors retail industry are also suggesting strong trading conditions.

3. We think the market is underestimating the impact of SUL's market-leading brands/positioning across Super Cheap Auto, BCF and Rebel Sport. BCF typically has a strong summer offer, and overweight is QLD (which is likely to emerge as a strong holiday destination for domestic holidaymakers). This summer also sees the comparison with soft sales comps from the bushfire impacted 2019/20 Summer – which is particularly the case for BCF.

4. SUL's relative infancy in online remains a clear opportunity, particularly with almost 20% of Australians being a member of one of SUL's loyalty programs.

5. SUL offers 10% earnings per share growth (EPSG) into FY21E and <5% in FY22E, which we think looks conservative against an improving domestic backdrop. SUL trades at price earnings ratio (PER) 15x, much cheaper than ARB at >30x, and BAP at 24x, with all three companies producing return on equity in the 10-15% range.

Amcor (AMC)

Rotating away from defensive growth:

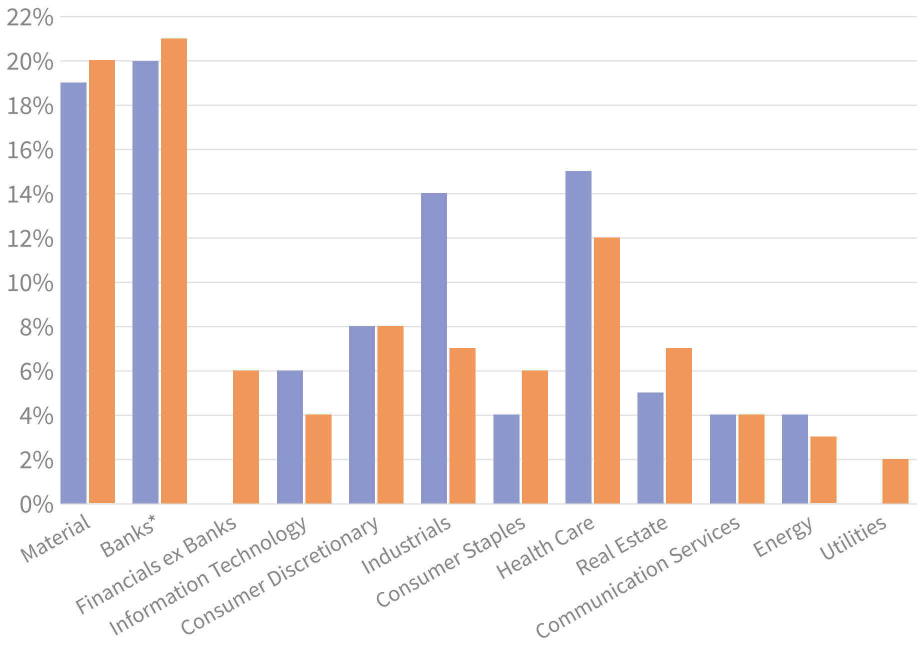
1. AMC has outperformed the market since mid-year as investors have been attracted to defensive/ growth attributes underpinned by its core product focus on consumer packaging productions. Increased investor familiarity in the US, which is now home to AMC's primary listing, has also helped the share price, along with confidence around synergies from the Bemis acquisition.
2. In a market which is likely to become more focused around earnings recovery beneficiaries, AMC is more likely to perform in line with the market or even be used as a funding vehicle as investors look to rotate into more recovery sensitive companies.

Banks (+1% CBA, +3% ANZ)

The case for continued underperformance is reduced:

1. A domestic recovery, led by a Victorian reopening, is likely to be beneficial to the banks. Lower unemployment and economic activity from a reopening should improve investor confidence in the banks' bad debts and future earnings expectations.
2. Valuation – the bank sector continues to trade under 1.0x price-to-book ratio (P/B ratio), approaching the 0.95x level of late May. A P/B ratio < 1x implies the banks are eating into their capital base and are unable to replenish that capital – something we disagree with. We believe the banks are undervalued at present.
3. We believe that proposed changes to credit framework should support loan growth, with a faster loan approval process and lower litigation risk.
4. The Federal Budget – although stimulus was widely anticipated, support for SMEs and tax cuts should boost business investment and consumption, increasing credit quality and loan growth.

Exhibit 7: Focus List sector weights versus market



AEQ Portfolio Weight ASX 200 Weight

* Banks defined as ANZ, CBA, NAB, WBC, BOQ, BEN, MQG.
Source: Refinitiv, Wilsons.

Exhibit 8: Bank sector P/B ratio at trough levels

ASX200 Banks IG - 12MTH FWD P/BPS 10 Year Average

Source: Refinitiv, Wilsons

5. As a result of these changes, we are now market weight the major banks. We believe the probability of a broader recovery is increasing, which reduces the risk of further bank underperformance.

Link Group (LNK -3%)

Takeover interest closes valuation gap:

1. LNK disclosed that Carlyle Group and Pacific Equity Partners made an indicative offer of $5.20 a share, valuing the company at $A2.8bn. This is a 30% premium to the pre-bid share price and implies 24x PER multiple. This follows a period where earnings have almost halved for LNK, despite the asset base growing.
2. We have previously highlighted the markets mispricing of LNK, classifying LNK as an asset value play. The market was ignoring the potential for earnings improvement and ascribing very little to no value to LNK's PEXA business, which was last valued at $1.6bn in 2018.
3. We have removed LNK from the Focus List. While a higher bid cannot be ruled out, the earnings environment for LNK remains uncertain against a key management change which is currently underway. We elect to reinvest outside playing further potential M&A upside.

Australian Equity Market Outlook: Constructive Despite Near-Term Uncertainties

Global and domestic equity markets face an uncertain near-term outlook in respect of the run-in to the US election and short-term path of the pandemic. Nevertheless, the backdrop of ultra-low rates and massive fiscal spending continues to provide a supportive environment for equities over the next 12 months.

Global vaccine prospects have improved from mid-year, and with several candidates now well into stage 3 trials, there is potential for positive news flow either later in Q4 or Q1 next year.

Any vaccine roll-out will take time, but the share-market will react to the news on trial success rather than waiting for a successful roll-out.

The local equity market has been locked in a reasonably narrow trading range since early June. Australia has been dealing with its own COVID-19 second wave (Victoria) with economic momentum faltering somewhat, however, prospects for a broader reopening are becoming more tangible, and a pro-growth Federal budget should lift business and consumer sentiment.

The Australian equity market with its low tech, high banks and resources weighting is also well-placed to participate in any global "recovery rally", so the risk return trade-off for the Australian equity market has become more appealing.

Additionally, we believe the market is likely to be underestimating the degree of potential earnings recovery over the next 2 years due to the current depressed level of earnings estimates.

Wilsons Australian Equity Focus List

Ticker	Company Name	Sector	Focus List Weight	Classification	EPS CAGR (FY1-FY3)	PE (FY1)	Div Yield (FY1)	ROE (FY1)
ANZ	ANZ	Financials	7.0%	Cyclical Value	16%	13.8	3.1%	6%
APX	Appen	Information Technology	3.0%	Secular Growth	35%	58.0	0.3%	14%
ALL	Aristocrat Leisure	Consumer Discretionary	3.5%	Cyclical Quality Growth	47%	41.1	0.1%	20%
AZJ	Aurizon Holdings	Industrials	3.0%	Defensive Growth	9%	16.5	6.1%	12%
BHP	BHP Group	Materials	10.0%	Cyclical Quality Growth	-5%	12.7	4.0%	21%
CBA	CBA	Financials	7.0%	Cyclical Quality Growth	11%	17.4	3.8%	10%
CKF	Collins Foods	Consumer Discretionary	2.0%	Defensive Growth	12%	26.8	2.0%	12%
CGC	Costa Group Holdings	Consumer Staples	2.0%	Asset Valuation Plays	27%	31.7	1.9%	8%
CSL	CSL	Health Care	7.0%	Secular Growth	11%	42.7	0.7%	31%
GMG	Goodman Group	Real Estate	5.0%	Secular Growth	11%	30.1	1.6%	10%
JHX	James Hardie Industries	Materials	3.0%	Cyclical Quality Growth	15%	29.6	0.0%	28%
MQG	Macquarie Group	Financials	6.0%	Cyclical Quality Growth	21%	21.3	2.8%	10%
NWS	News Corporation	Communication Services	4.0%	Asset Valuation Plays	49%	55.0	1.0%	2%
NST	Northern Star Resources	Materials	3.0%	Defensive Growth	12%	17.2	1.4%	28%
OZL	OZ Minerals Limited	Materials	3.0%	Cyclical Value	39%	26.4	1.4%	6%
RWC	Reliance	Industrials	3.0%	Cyclical Value	9%	21.8	2.2%	11%
RMD	ResMed	Health Care	6.0%	Secular Growth	11%	36.7	0.7%	25%
STO	Santos Limited	Energy	4.0%	Cyclical Value	35%	22.0	1.0%	5%
SUL	Super Retail	Consumer Discretionary	3.0%	Cyclical Value	2%	15.2	4.1%	16%
SVW	Seven Group Holdings	Industrials	4.0%	Cyclical Value	11%	16.3	2.2%	14%
TLX	Telix Pharmaceuticals	Health Care	2.0%	Secular Growth	0%	n/a	0.0%	-57%
A2M	The a2 Milk Company	Consumer Staples	2.0%	Secular Growth	18%	28.7	0.0%	29%
TCL	Transurban Group	Industrials	4.0%	Defensive Growth	16%	30.4	2.9%	0%
XRO	Xero Limited	Information Technology	3.5%	Secular Growth	36%	n/a	0.0%	9%

Source: Refinitiv, Wilsons

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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