WILSONS

Rotating Further Towards Cyclical Recovery

Our monthly Australian equities report.

12 November 2020

The Case for Rotation

The list of ingredients needed for cyclical recovery continues to build. This month we have further rotated the Wilsons Australian Equity Focus List towards cyclical recovery beneficiaries which now comprise 60% of the Focus List, up from 45% in September. New developments in the COVID-19 vaccine race this week further support this case.

Read more Australian Equities: Underappreciated in a Global Context.

In our view, Australia can emerge from the COVID-19 hibernation in a stronger position than the rest of the world. Enlarged fiscal and monetary support – some of the largest in the OECD, with the potential for further domestic reopening by the end of 2020 – all support the case for rotation into cyclical recovery plays within Australian equity portfolios.

Changes to the Focus List

For the Focus List, we have increased our exposure to banks, which we see as a domestic cyclical recovery beneficiary. We are now modestly overweight (including Macquarie Group), with the addition of NAB. Trading under book value, NAB reported the strongest result of its peers with management renewal complete – setting the group up for improved performance.

Worley (WOR) has been added for its cyclical exposure across energy and chemicals. WOR remains well placed to benefit from increased spend as the world begins the pathway to normality. Strong operating leverage inherent within its business model could see earnings significantly rebound in future years.

We have cut our weighting in half to News Corporation (NWS), and by two thirds for ResMed (RMD). Both have reported strong earnings results in the last two weeks, followed by a strong share price reaction. Collins Foods (CKF) has been removed from the Focus List to make way for increased exposure to companies with greater cyclical earnings potential.

Ingredients for a Cyclical Recovery

Four significant events over the last month have provided the ingredients for cyclical recovery in Australian earnings and share prices – particularly for companies where earnings have been significantly impacted due to COVID-19:

1. **Vaccine developments** – Recent news flow from Pfizer and Elly Lilly supports a vaccine being available for widespread distribution from early 2021. This does not end the disruption caused by COVID-19 but provides a light at the end of the tunnel for markets, while removing downside tail risks.

2. **Double-barrelled Australian stimulus** – The October Federal Budget delivered the largest fiscal stimulus program in modern times. The other hand of policy, the RBA, adopted a zero interest rate policy (ZIRP) framework which should ensure the Australian yield curve remains low and flat for an extended period. Importantly, both policy fronts came in ahead of market expectations.

3. **Australian earnings upgrade cycle** – We are seeing signs of an earnings upgrade cycle emerging domestically, reinforced by the positive start from the local AGM season. Similar earnings trends are also beginning in both emerging markets and the US.

   Read our report detailing why the AGM Season Points to an Earnings Upgrade Cycle.

4. **US Recovery** – With the US election now out of the way, the markets focus will switch to a probable large scale fiscal stimulus – likely 1Q21. In the meantime, US companies continue to create new jobs. Half the ~22m jobs lost due to COVID-19 have been reinstated, while October saw almost ~1m new private-sector jobs created. The ongoing recovery in the US is important in helping set the tone for global cyclical recovery, and recovery in equity markets in part given its sheer size.

Market conditions are also conducive to cyclical rotation. The valuation disparity between growth (high price to earnings ratio - PER) and value (low PER) matches for the first time what we saw in the early 2000s. In the US, the PER differential is almost 18 PER points between the most expensive and the cheapest companies.

There is a scenario where both earnings and earnings multiples for recovery beneficiaries improve over a similar time period. This would likely lead to dramatic outperformance versus the market. In our view, a COVID-19 vaccine is the key enabler of a potential unwinding of this valuation dichotomy, and investors need to take note.

Exhibit 1: Value/growth relative performance - COVID-19 has widened the gap and vaccine developments could slow or even reverse this trend

Source: State Street Global Investors, Refinitiv, Wilsons.
Price index, S&P 500 growth price index and S&P 500 value - price index.

Wilsons Australian Equity Focus List

Within the quality/growth style constraints of the Wilsons Australian Equity Focus List we have been balancing the dilemma of positioning for a COVID-19 recovery without sacrificing too much in the way of quality.

Our aim was to avoid getting caught in potential vaccine recovery plays where either the earnings or perhaps the companies have been permanently impaired.

In September, we showed that the Focus List had around 30% exposure to direct COVID-19 recovery beneficiaries. In addition, a 25% exposure to resources would also likely see the Focus List well-positioned for any vaccine news.

Read our September report.

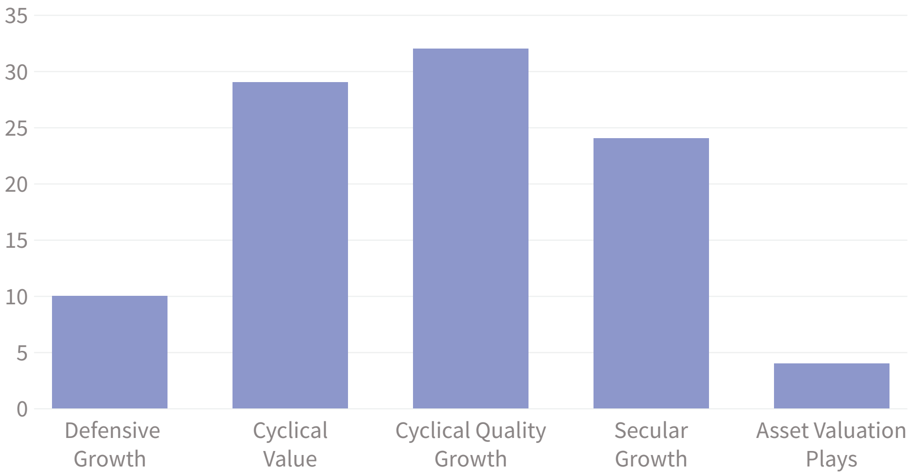
In October, we further rotated the Focus List into recovery beneficiaries, adding to the banks and rotating further away from defensive companies.

Read our October report.

To date, this strategy has worked well for the Focus List. Since its inception in late May 2020, the Focus List has outperformed the S&P/ASX 200 by around 3.50%.

In the first 3 months, a strong focus on quality (i.e. ROIC > WACC) and being underweight financials enabled outperformance.

Exhibit 2: Focus List – 60% of the Focus List has exposure to cyclical earnings



Source: Wilsons.

In recent months, at the margin, we have relaxed our quality criteria and rotated the Focus List further into cyclical recovery exposures. We have moved to an overweight position on the banks.

Focus List Changes

This month we continue the rotation into cyclical recovery beneficiaries. We have increased confidence around a cyclical recovery, particularly with recent vaccine-related news supporting the move.

We have added 8% points of exposure to the banks and industrial cyclicals, while reducing (by the same amount) exposure to COVID-19 winners in healthcare and consumer discretionary.

The three common characteristics of companies we are adding include:

1. Share prices below pre-COVID-19 levels
2. Earnings below pre-COVID-19 levels
3. Our view that COVID-19 has not permanently impaired the earnings generation of the company

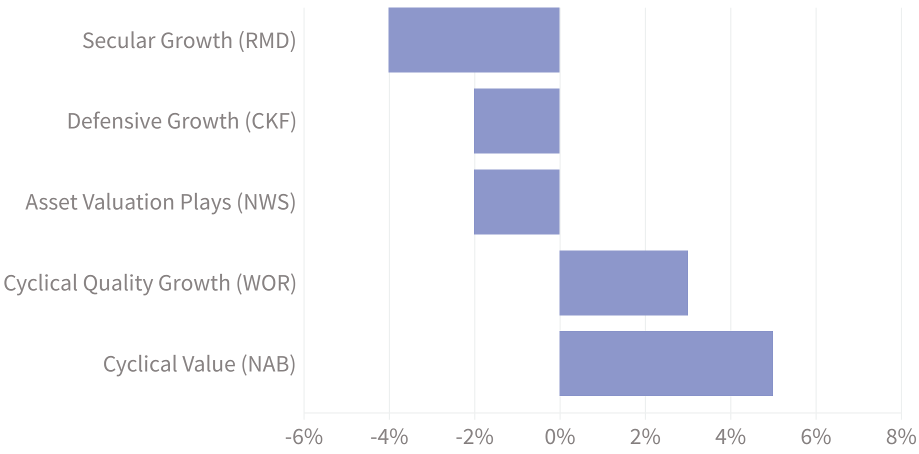
Now is the Time to Further Rotate into Earnings Recovery Beneficiaries

The pathway to normal is likely to be bumpy. This week's early vaccine news is far from the end prize, and there remains a number of questions around wide-scale vaccine deployment and speed at which the reopening of economies can occur.

The key interpretation from a market's perspective is the reduction in the probability of a downside COVID-19 event for economies and markets. The vaccine news provides a potential pathway through the COVID-19 economic dislocation for the first time since March 2020.

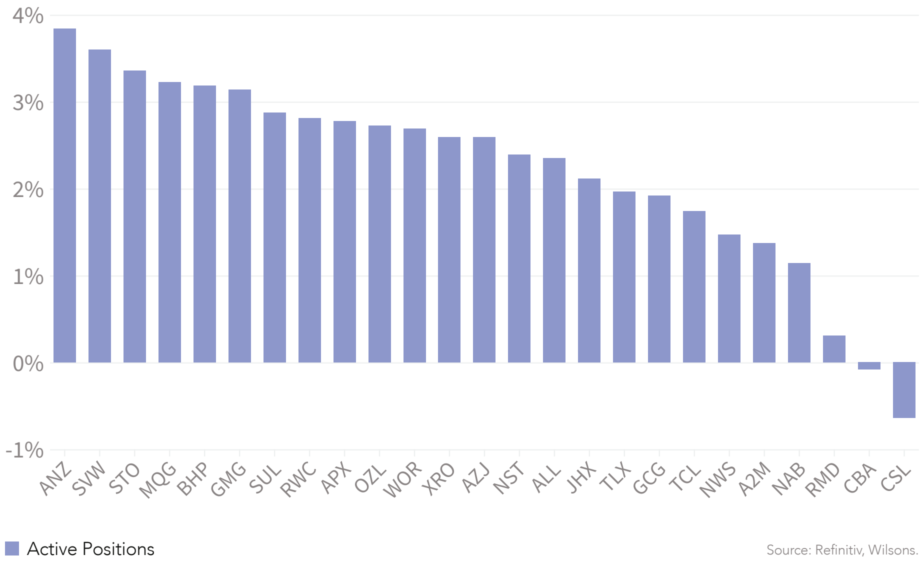
It is likely to take a number of months for equity markets to fully price the recovery as evidence builds around vaccine approvals and economic reopening. With cyclical recovery beneficiaries in many cases well below pre–COVID-19 levels, we believe investors should be rotating into earnings recovery beneficiaries now.

Exhibit 3: Focus List - Further rotation into cyclical recovery exposures



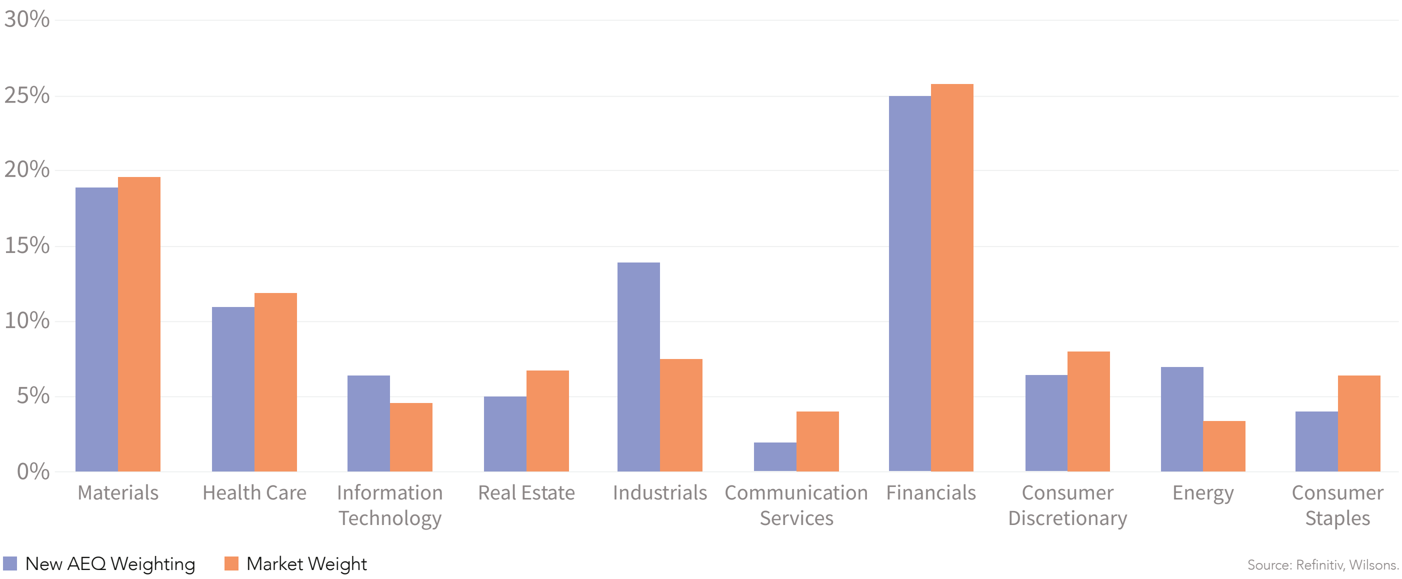
Source: Wilsons.

Exhibit 4: Focus List active weights



Source: Refinitiv, Wilsons.

Exhibit 5: Focus List sector weights versus index



Source: Refinitiv, Wilsons.

Company Changes Explained

Worley (WOR)

Sector	Energy
Weight	3%

WOR has diversified its revenue exposure over the last 3 years with the acquisition of Jacob's Energy in 2018. WOR now has a higher exposure to chemicals, while reducing their oil and gas exposure. The change has resulted in WOR becoming a more resilient business which is significant in a volatile period for commodities.

Economic reopening (assisted by vaccine developments) has the potential to materially tighten oil markets more significantly than what the market is currently factoring. This could see a material rerate of WOR earnings multiple and earnings. The market is currently forecasting earnings per share (EPS) rising from 67 cents per share (CPS) in FY20A to 88cps in FY23E, or ~15% pa. If the global capex cycle really turns, market estimates for FY23 earnings could be significantly underbaked.

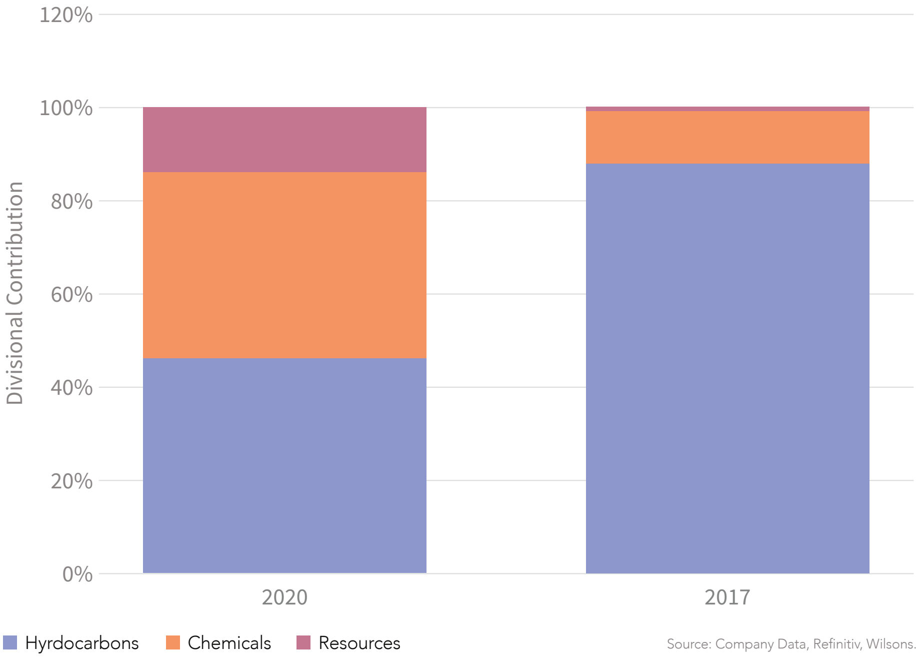
Escalation in the cost-out program ($165m of the $275m program was delivered in FY20), along with a cyclical recovery should be positive for earnings and dividend growth over the next few years.

WOR has the flexibility to ride the next wave of energy capex as the services business is not confined to oil and gas. WOR can transition to the greener parts of the energy sector as the global demand for non-fossil fuels accelerates, providing additional growth and further diversification.

Exhibit 6: WOR offers the prospect of strong cyclical earnings recovery

Source: Refinitiv, Wilsons.

Exhibit 7: Worley's earnings mix has changed dramatically, remains an economic reopening beneficiary



Source: Company Data, Refinitiv, Wilsons.

NAB (NAB)

Sector	Financials
Weight	5%

NAB is primarily a macro call on the recovery in earnings – first by lower bad debts, and secondly improved pre-provision earnings as the recovery takes shape. At <0.9x book value this seems mispriced given our view that NAB can generate ROIC>WACC over the next 3 years.

NAB reported the strongest result of peer banks in the recent FY20 reporting. We liked early evidence of revenue momentum and stronger handle on cost growth into 2021 versus peers. Provision coverage looks best in sector, Tier-1 capital position (equity raising in 2QCY20) at 11.5% rising to >12% in FY21 suggests dividend in coming years can be supplemented by capital returns to shareholders.

There is also an element of self-help with the NAB investment case. Greater capital discipline and a strong position in business banking with a now complete new management team can potentially see NAB's perennial discount to peers close over time.

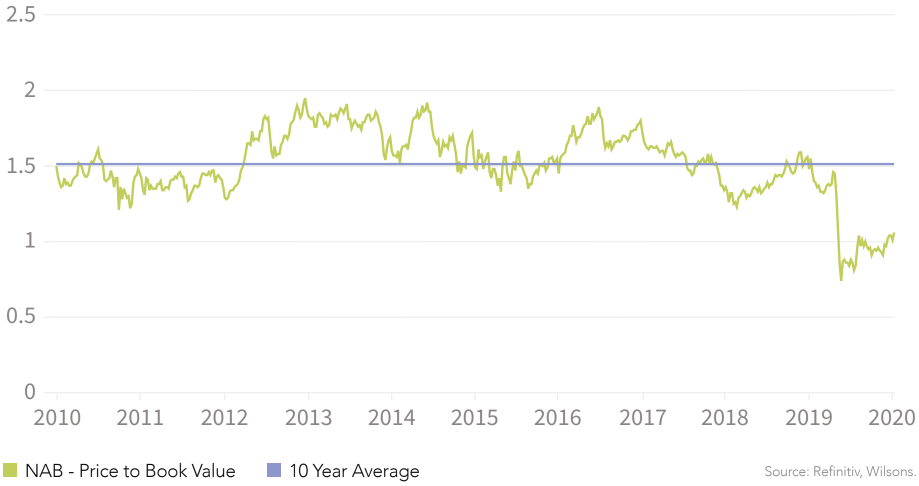
ResMed (RMD)

Sector	Health Care
Weight	Reduced to 2%

We believed the negative reaction to the FY20 results in August was excessive, increasing the weighting of RMD to 6% from 4% in response to what we believed was an overreaction by the market.

The results for 1Q21 were strong and the market repriced RMD to all-time highs. We are trimming our position in RMD to take these profits at the current valuation.

Exhibit 8: NAB price to book



Source: Refinitiv, Wilsons.

News Corp (NWS)

Sector	Communication Services
Weight	Reduced to 2%

NWS is an asset valuation play. When we added NWS, we believed the market did not appreciate the overall value of the group's assets. This has partly paid out, with share price gap to our valuation having partially closed.

A large 1Q21 earnings beat, stronger segmental disclosure and investor excitement about the prospects of improved earnings within NWS's real estate assets have seen the share price rally aggressively.

With the validation gap now partly closed, coupled with no identifiable stock-specific catalyst in the short-term, we have reduced our exposure by half.

There remains potential to restructure further and/or spin-off the real estate assets. It is not out of the question given improved REA Group (REA) and Move Inc (MOVE) share prices, and prospects of improving residential property markets, that 2021 is the year of a large value enhancing restructure at NWS.

Collins Foods (CKF)

Sector	Consumer Discretionary
Weight	Removed

CKF has performed well in the Wilsons Australian Equity Focus List since inception, generating total returns ~30%. However, we believe the stock has been a COVID-19 beneficiary and could be used to fund more cyclical exposures by investors.

Earnings risks in our view have moved from upside risk to neutral/down. European lockdowns are likely to have some impact on earnings, potentially offset from a stronger Australian summer. Earnings risks are now less clear than where they were a month ago.

Focus List Alphabetical Table

Ticker	Name	Sector	Focus List Weight	New Weighting	Classification	EPS CAGR (FY1-FY3)	PE (FY1)	Div Yield (FY1)	ROE (FY1)
A2M	The a2 Milk Company	Consumer Staples	2.0%	2.0%	Secular Growth	18%	28.3	0.0%	29.1%
ALL	Aristocrat Leisure	Consumer Discretionary	3.5%	3.5%	Cyclical Quality Growth	48%	43.9	0.1%	20.1%
ANZ	ANZ	Financials	7.0%	7.0%	Cyclical Value	10%	12.5	4.6%	7.5%
APX	Appen	Information Technology	3.0%	3.0%	Secular Growth	35%	55.1	0.3%	14.3%
AZJ	Aurizon Holdings	Industrials	3.0%	3.0%	Defensive Growth	8%	15.1	6.6%	11.7%
BHP	BHP Group	Materials	10.0%	10.0%	Cyclical Quality Growth	-8%	12.0	4.1%	21.7%
CBA	CBA	Financials	7.0%	7.0%	Cyclical Quality Growth	11%	18.6	3.5%	9.6%
CGC	Costa Group Holdings	Consumer Staples	2.0%	2.0%	Asset Valuation Plays	24%	31.1	2.0%	8.1%
CKF	Collins Foods	Consumer Discretionary	2.0%	0.0%	Defensive Growth	12%	24.9	2.1%	12.3%
CSL	CSL	Health Care	7.0%	7.0%	Secular Growth	12%	45.1	0.7%	31.2%
GMG	Goodman Group	Real Estate	5.0%	5.0%	Secular Growth	11%	29.5	1.6%	10.5%
JHX	James Hardie Industries	Materials	3.0%	3.0%	Cyclical Quality Growth	14%	27.9	0.1%	30.5%
MQG	Macquarie Group	Financials	6.0%	6.0%	Cyclical Quality Growth	21%	23.1	2.5%	10.5%
NAB	NAB	Financials	0.0%	5.0%	Cyclical Value	10%	16.5	4.0%	8.0%
NST	Northern Star Resources	Materials	3.0%	3.0%	Defensive Growth	14%	16.9	1.5%	26.4%
NWS	News Corporation	Communication Services	4.0%	2.0%	Asset Valuation Plays	43%	57.8	0.9%	2.3%
OZL	OZ Minerals Limited	Materials	3.0%	3.0%	Cyclical Value	38%	25.7	1.4%	6.4%
RMD	ResMed	Health Care	6.0%	2.0%	Secular Growth	11%	41.4	0.6%	27.1%
RWC	Reliance	Industrials	3.0%	3.0%	Cyclical Value	9%	22.1	2.1%	10.7%
STO	Santos Limited	Energy	4.0%	4.0%	Cyclical Value	43%	27.7	0.8%	4.2%
SUL	Super Retail	Consumer Discretionary	3.0%	3.0%	Cyclical Value	-4%	11.7	5.3%	18.6%
SVW	Seven Group Holdings	Industrials	4.0%	4.0%	Cyclical Value	11%	16.5	2.1%	14.4%
TCL	Transurban Group	Industrials	4.0%	4.0%	Defensive Growth	17%	n/a	2.6%	-0.7%
TLX	Telix Pharmaceuticals	Health Care	2.0%	2.0%	Secular Growth	n/a	n/a	0.0%	-27.4%
WOR	Worley	Energy	0.0%	3.0%	Cyclical Quality Growth	15%	15.8	4.1%	5.8%
XRO	Xero Limited	Information Technology	3.5%	3.5%	Secular Growth	88%	n/a	0.0%	8.9%

Source: Refinitiv, Wilsons.

Disclaimer and disclosures

Recommendation structure and other definitions

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

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