WILSONS

2020 Focus List Stocktake

Our monthly view on Australian equities.

10 December 2020

Looking Back and Ahead

With 2020 drawing to a close, we take stock of how the Wilsons Australian Equity Focus List has performed through the year and show how the List has significantly pivoted over the past 6 months as both the health and economic landscape have evolved.

Casting our eyes forward to 2021, we remain upbeat around the outlook for the domestic economy and believe Australian corporate earnings can go into upgrade mode through 2021. Recent updates on business confidence and job ads point to a strengthening outlook domestically, with the latter close to returning to pre-COVID-19 levels.

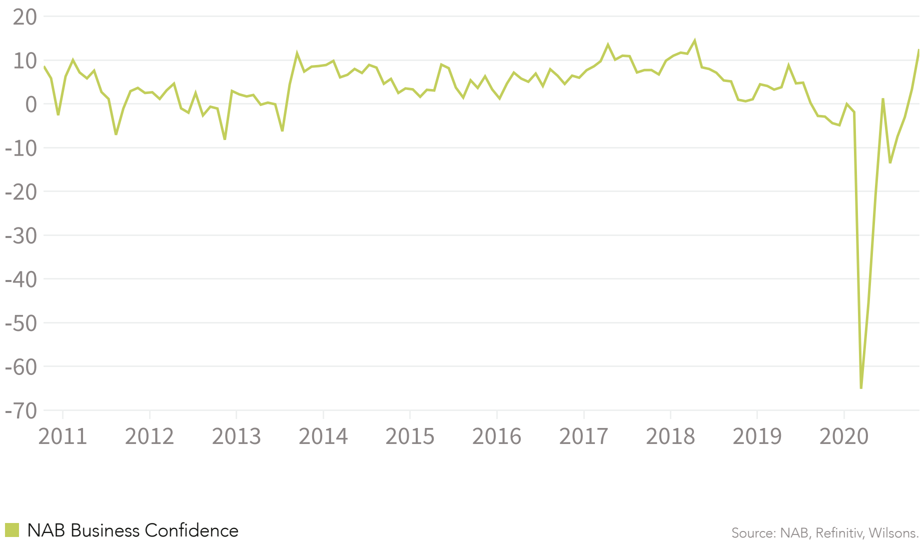
Read our deep dive on How Long Before a Vaccine can Restore Earnings.

Australia can potentially benefit from style rotation in markets driven by global recovery prospects. The value orientation of the market, with banks and resources making up around half the market, being the key reason. Additionally, Australia lacks large exposure within the index to high-growth (high-multiple) companies which have led global equities over the past 5 years.

Focus List changes

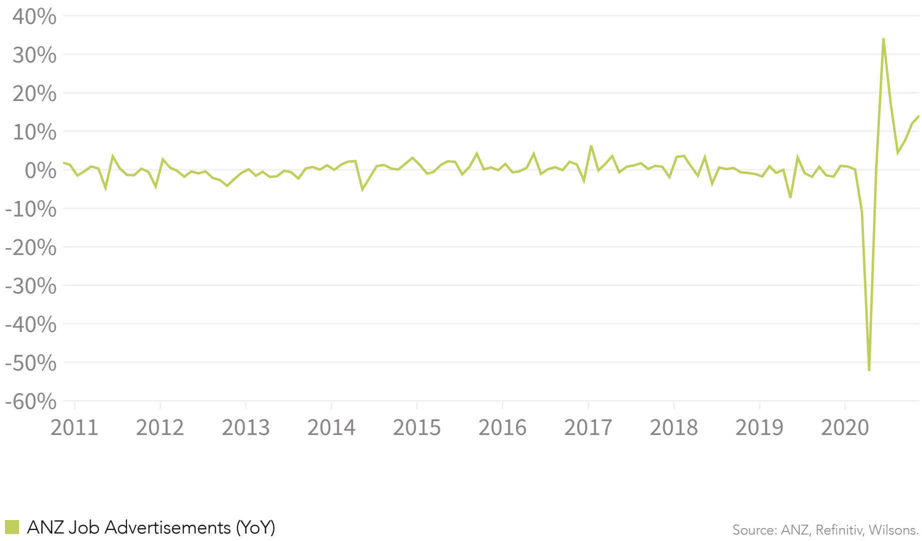
We have made a small change to the Focus List, adding EML Payments (EML) and removing Costa Group (CGC) after a period of strong performance. EML provides exposure to a secular growth thematic of payments, with earnings.

Exhibit 1: Business confidence has roared back to life



Source: NAB, Refinitiv, Wilsons.

Exhibit 2: ANZ job ads have followed a similar pattern as domestic economy reopens



Source: ANZ, Refinitiv, Wilsons.

Performance Stocktake

In May we described the Focus List as having a mandate to look at quality/growth-orientated companies – companies that have the ability to generate superior long-term returns for investors. Having exposure to a group of quality/growth-oriented companies is a proven way to create long-term wealth for investors.

It remains our view that while the macro backdrop is something we need to consider and be aware of, it is the long-term compounding impact of individual company earnings that creates long-term value for investors.

Since inception in May 2020, Focus List stocks have generated a total return of 27% relative to the market at 19%.

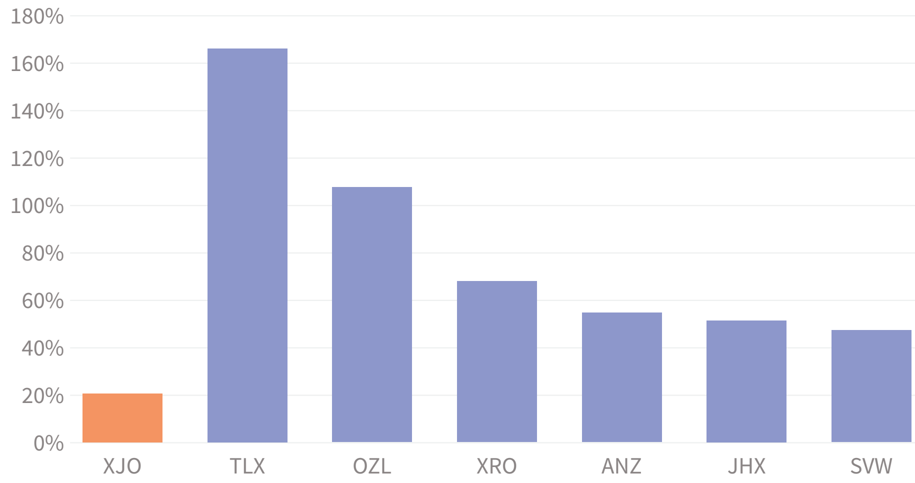
For us, the two pleasing aspects have been:

1. The relative consistency of performance delivery against a market which had two distinct periods of performance through the May-Oct COVID-19 winner/loser thematic, followed by the vaccine-led value-growth rotation in November.
2. The breadth of stocks which contributed to performance, with more than 80% of all members positively contributing.

While the Focus List has an overarching quality/growth style, it is not so fixated on style attributes that it ignores companies that are mispriced relative to long-term growth prospects. We are cognisant of being able to generate performance through different market environments without being locked into a single style.

By way of illustration, cyclical company exposures by weighting are now at 65% versus 40% back in May. Being able to pivot the Focus List ahead of this large November rotation was important.

Exhibit 3: Focus List top 6 total returns since inception



Source: Refinitiv, Wilsons.

Exhibit 4: Focus List cyclical exposures have increased ahead of vaccine release

Source: Refinitiv, Wilsons.

Our Learnings

That's not to say everything has gone our way. Indeed mistakes were made.

We missed the first aggressive rotation into the banks in late May as we were aggressively underweight.

A2 Milk (A2M) was held for too long before we cut the exposure altogether – we had underestimated the logistics issues into China.

Aurizon (AZJ) has arguably offered too much value and not enough growth, with an earnings downgrade in August. The stock has underperformed since May, with the rotation rally in November offering some relief.

What did we learn from this? Stay vigilant of the facts, and when they change, recognise the threat this potentially presents to stock price performance.

The Focus List's Position into 2021

Going into 2021, the Focus List remains true to the label – long on growth, long on quality.

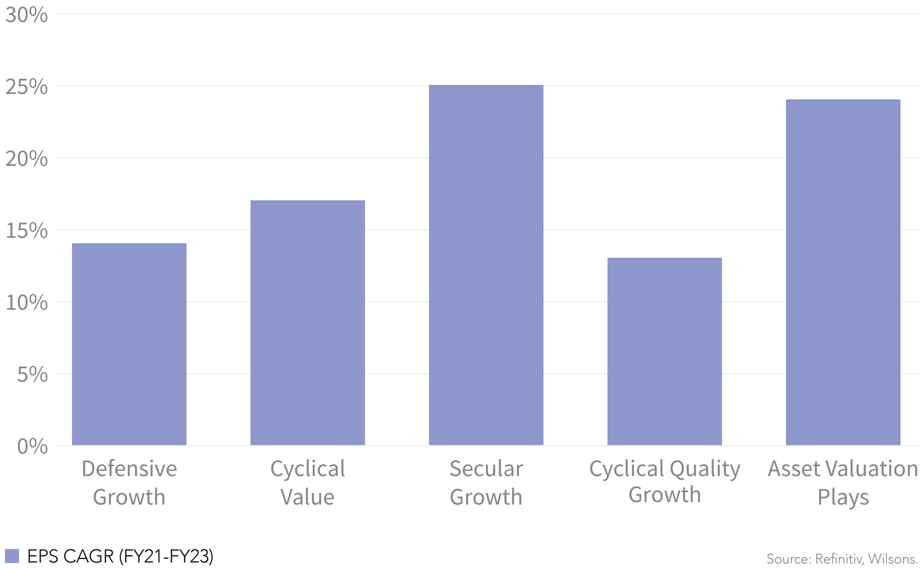
Earnings growth of Focus List companies remains well above the market at 18% compound annual growth rate (CAGR) over the next 3 years.

The market may be too conservative on earnings estimates for cyclical value companies over the coming 3 years. The relative differential to market earnings estimates in defensive growth looks suspiciously small, particularly coming out of the depressed level of the FY20 earnings base.

Return on equity (ROE) as a measure of quality remains a strong feature of the Focus List with an average ROE of 13.6% (market ~10%). Unsurprisingly, the asset valuation plays and the cyclical value sectors have the lowest ROE given the structural return issues these two sectors have.

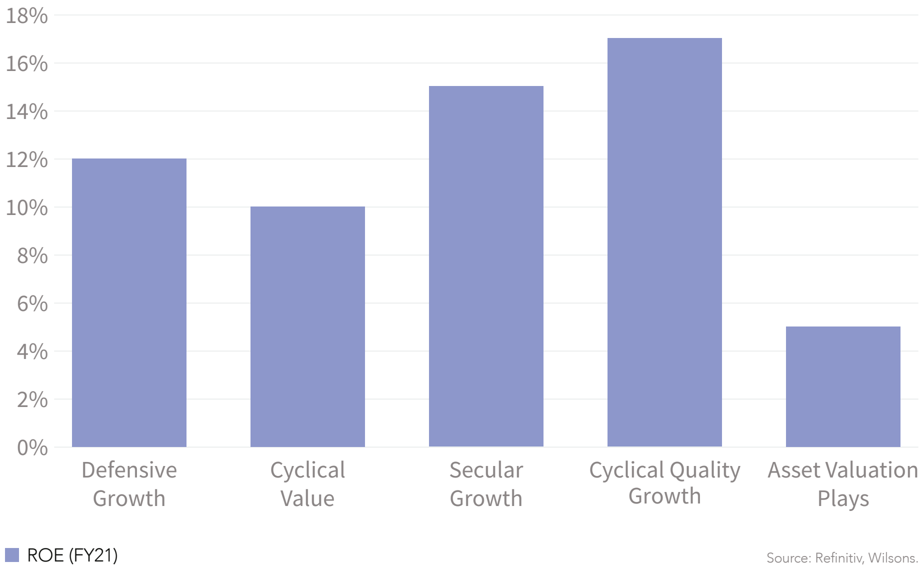
While we caution from being too focused on FY21 PE given low rates and depressed earnings, PE remains elevated across all our sectors. In aggregate, the Focus List has PE 26x versus 21x of the market. This probably understates the true PE of the Focus List as we have not included the PE for very high PE companies like Transurban Group (TCL), Telix Pharmaceuticals (TLX) and Xero (XRO).

Exhibit 5: Focus List – earnings growth by sector



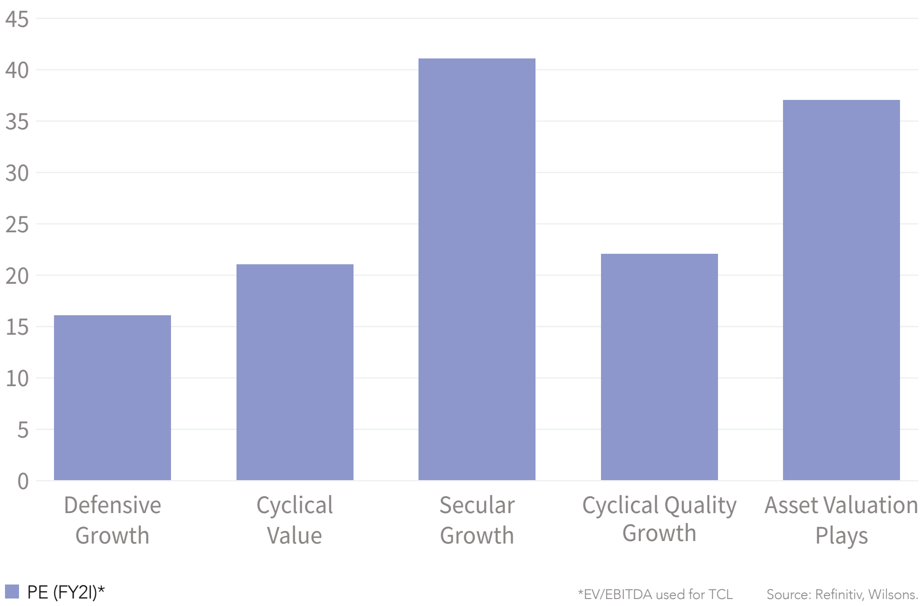
Source: Refinitiv, Wilsons.

Exhibit 6: Focus List quality – ROE by sector



Source: Refinitiv, Wilsons.

Exhibit 7: Focus List valuation – PE by sector



*EV/EBITDA used for TCL

Source: Refinitiv, Wilsons.

Focus List Changes

EML Payments (EML) - added 2% weight

EML is an Australian-based global fintech specialising in payment solutions. EML provides full-service payment solutions primarily on a B2B basis. While COVID-19 has impacted revenues during 2020, they are expected to rebound relatively quickly in 2021. The longer-term thematic exposure to cashless society has accelerated due to COVID-19 providing a longer-term tailwind. The 2020 acquisition of Prepaid Financial Services (PFS) increases the Group's exposure to Europe and the fast-growing neo banks.

From a growth perspective, Gift & Incentive cards and General Purpose Reloadable are the core drivers of organic growth over the coming years. From a growth perspective, 2yr CAGR EBITDA is expected to increase +45% pa, close to double that of international high-growth fintech peers.
From a valuation perspective, the EV/EBITDA multiple of 17x (Wilsons numbers), is a discount of more than 20% to the same peer set.

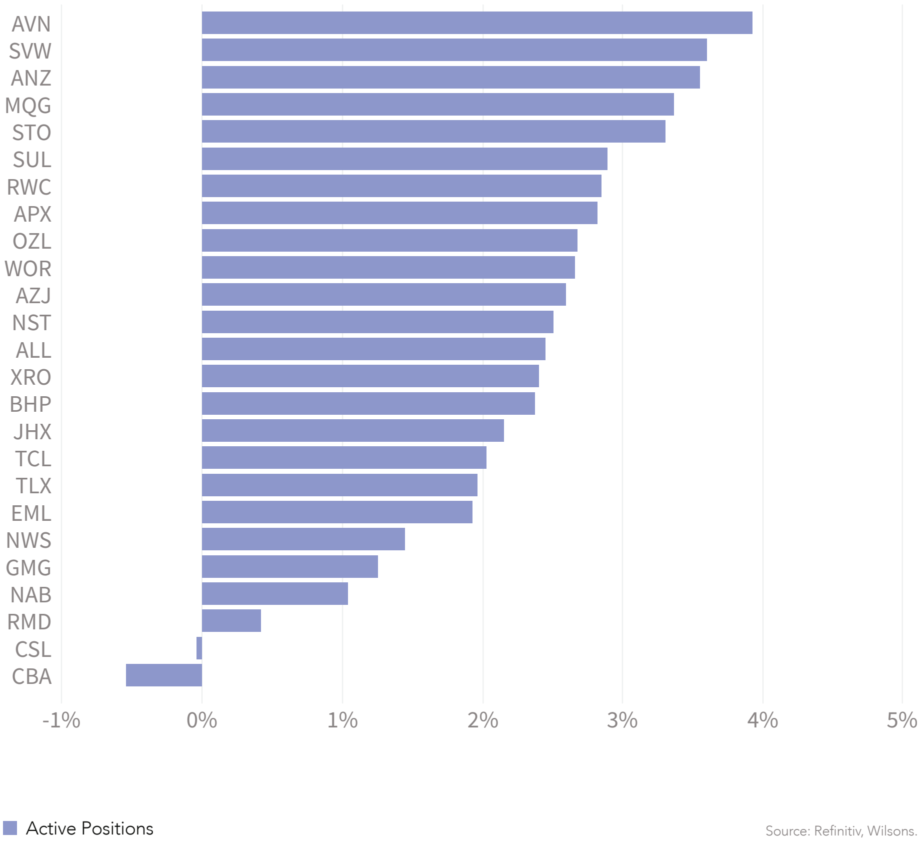
Costa Group (CGC) - removed, was 2% weight

We have removed CGC following a 25% rise in the share price since we placed CGC into the Focus List. The earnings outlook has improved materially, and operational execution relative to 2019 has also been more consistent.

While the outlook for earnings improvement over the coming years remains in place, valuation appeal is no longer as large with CGC now at PE 23x FY22E versus 18x when we initiated the position. PE relative to the market has closed significantly.

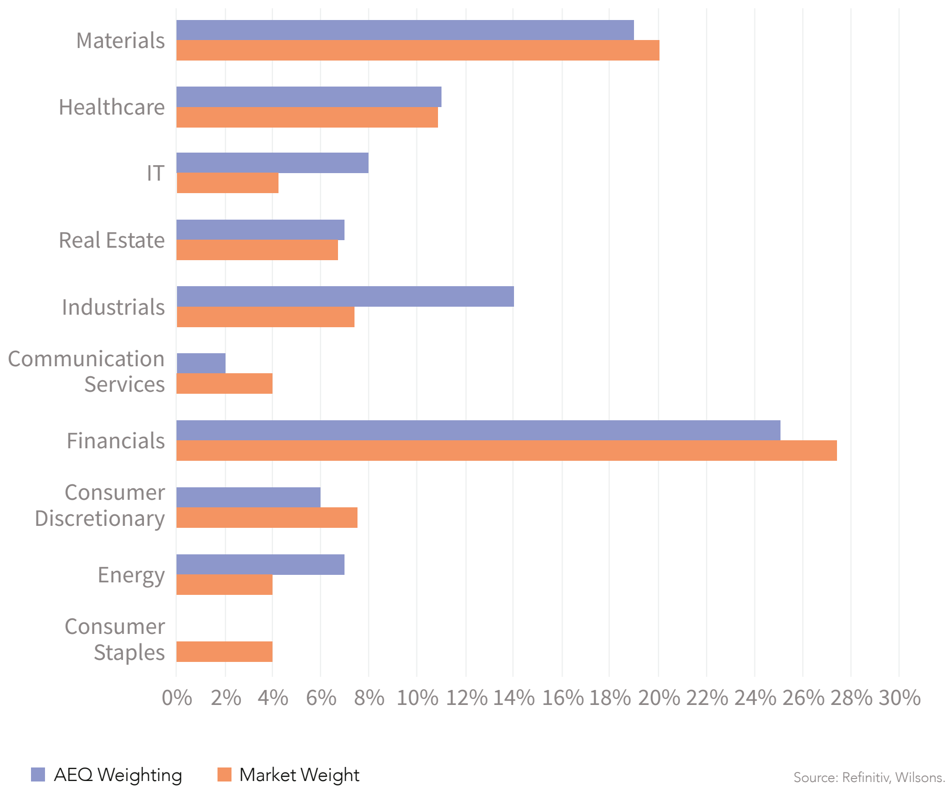
The company has flagged long standing CEO, Harry Debney will be stepping down from the role at some stage in 2021. This creates some incremental transition risk to the investment case.

Exhibit 8: Focus List active position versus market



Source: Refinitiv, Wilsons.

Exhibit 9: Focus List GICS level sector weights



Source: Refinitiv, Wilsons.

Focus List Highlighted Companies

We highlight our view on some key Focus List Companies, split between those that have had a strong performance and those where we expect improved performance in the coming months. In all cases, we believe further upside in share prices is available, largely driven by the company-specific attributes we expect to play out.

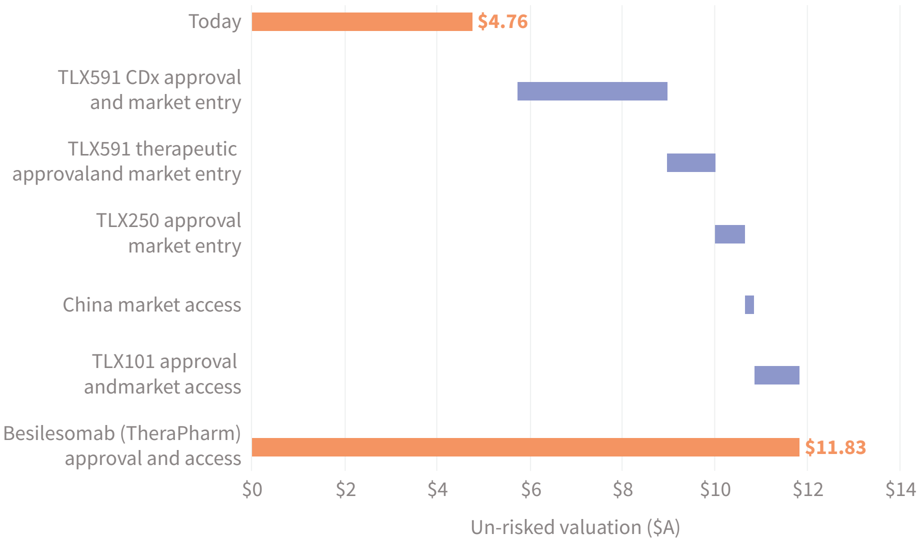
Telix Pharmaceuticals (TLX) - 2% weight

Telix has had a phenomenal second half with the share price up over 2.5x. We believe further share price upside exists, as regulatory approvals are potentially awarded in the coming years. We consider TLX as well-funded and not requiring additional equity under the current business plan, ahead of EBITDA breakeven in FY22.

Valuing the TLX opportunity is an exercise in judging probabilities. Our Wilsons analysts' base case valuation is $4.14. The un-risked valuation is almost 3x this value. Investors who have held TLX for a number of years will do well to consider their weighting in the stock. While the last few months have been exceptional, we remind investors that the pathways for biotech approval and commercialisation are not always the one way street of good news!

The catalyst/news flow pipeline remains strong into 2021. Positive news flow would potentially allow the market to move towards our un-risked valuation. What lies ahead for TLX:

Exhibit 10: Wilsons un-risked Telix valuation roadmap



Source: Wilsons.

- December 2020 - FDA Phase III trial approval. This potentially elevates TLX's TLX591 treatment ahead of Novartis' competing product.
- 1HCY21 - major market approvals for TLX's prostate cancer imaging product TLX591-CDx.
- 1HCY21 - ZIRCON trial results – potential fast-tracking of TLX renal cancer imaging product TLX250-CDx.
- We also expect results on Glioblastoma trials (brain cancer treatment), which if favourable could further open up a corporate appeal for TLX, sitting outside the central urologic oncology thematic.
- We consider TLX an attractive albeit high-risk investment (pre-earnings), and as such have just 2% of the Focus List in TLX.

Super Retail (SUL) - 3% weight

SUL has underperformed the market since we added the retailer to the Focus List. Despite the +10% earnings upgrade the company gave at the AGM (with VIC still in lockdown at the time), the market has viewed SUL as a COVID-19 beneficiary.

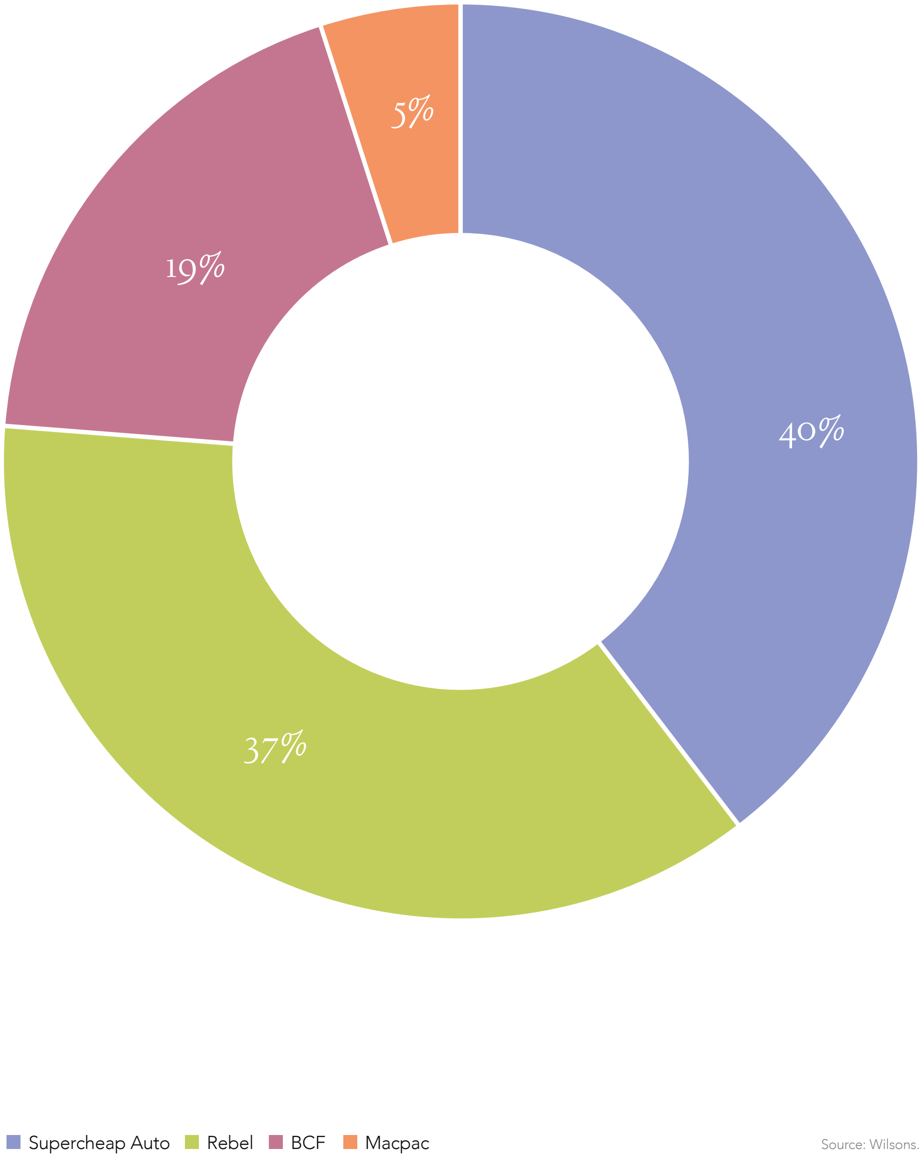
The share price has been negatively impacted by positive vaccine/reopening news. The valuation is more appealing today than when we entered the position at a PE of 11x FY21E and 12x FY22E. We continue to believe that earnings risks are building to the upside.

The summer period is likely to see buoyant volumes across autos, sports and BCF businesses (95% of Group revenue). Unlisted industry contacts continue to suggest elevated levels of activity remain in place.

ARB (ARB) in recent weeks has spoken about the record pipeline of activity. Adairs (ADH) has also reported continuing strong levels of sales with +17% like-for-like sales growth in the July to November period (ex-VIC).

A vaccine is unlikely to see material levels of offshore flights before 2HCY21, meaning domestic holidays, leisure, and recreation are likely to be in demand well into 2021. In short, we remain convicted on SUL.

Exhibit 11: Super Retail Divisional Earnings



Source: Wilsons.

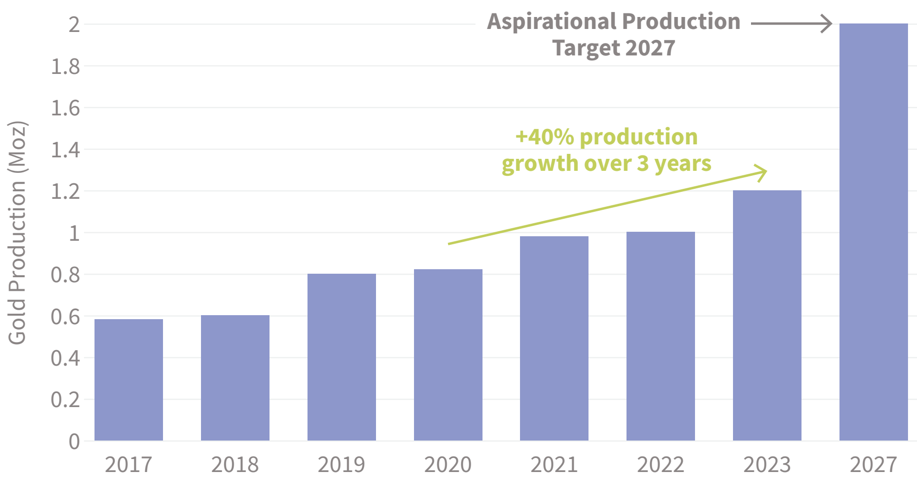
Northern Star (NST) - 3% weight

A pivotal year for Northern Star with the announced merger of fellow producer Saracen (SAR) in October. We think the transaction is not only highly accretive from an operational perspective, but now puts NST on the map to a wider audience of investors. Potentially, NST is an S&P/ASX 20 leaders constituent. Post-merger, NST's position of having the highest production growth over other Australian gold producers over the next 3 years remains. We think this is important, as it dampens the influence of the gold price on share price performance. It also allows NST to compound earnings independently of the gold price.

The stock price has retraced from all-time highs in the early $17s to be back at below $13. A falling gold price and rotation into cyclical sectors of the market has seen NST be used as a funding source for investors. We would argue that below $13, NST looks exceptional value.

Early in 2021 we should see deal approval for the NST/SAR merger. We think the market is underestimating the benefit of a combined NST/SAR. It must be remembered that the Kalgoorlie Super Pit operation (~50% of Group sales) is effectively a three-way merger between NST, SAR and Kalgoorlie Consolidated Gold Mines (JV with NST/SAR) which operates the mine. We think the opportunity to have a single owner for the first time in the mine's history is underappreciated by the market.

Exhibit 12: Northern Star production profile



Source: Company data, Refinitiv.

Appen Group (APX) 3% Weight

APX has underperformed the market since September. The lack of an earnings upgrade at 1H results frustrated investors after seeing strong business momentum in APX's key client's post-April.

In December, APX lowered FY20 earnings guidance by 15%, citing weaker clients demand in Nov/Dec. Weaker activity levels more than offsetting the uptick in new project wins, and client wins across new industry verticals like autos, education and logistics. Seasonality also plays a part, as traditionally the 4Q is APX's most profitable quarter.

Despite the price weakness, we are opting to maintain exposure to APX. We view the current soft operating conditions are temporary due to COVID-19 restrictions, particularly with major clients on the US West Coast.

Medium term industry growth rates don't appear to be challenged given recent commentary from either APX or US peer Lionbridge. We believe the long-term digitalization of the economy thematic remains in place. APX offers the potential to grow earnings at +35% over the next few years.

News Corporation (NWS) - 2% weight

When we added NWS in May we believed the market did not appreciate the overall value of the Group's assets. This has partly paid out over the year, with the share price gap to our valuation having partially closed. The stock is up ~40% since being added to the Focus List in May.

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 reduced our exposure by half in November.

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 the prospect of improving residential property markets, that 2021 is the year of a large value-enhancing restructure at NWS (spin-off or demerger of property/media assets).

Banks (CBA 7%, ANZ 7%, NAB 5% weight)

After a volatile 6 months the banks rallied in November, providing some of the best relative returns in the month. CBA, ANZ and NAB outperformed in November, generating absolute returns of 15%, 20% and 23% respectively. Post the November rally, we still believe the banks have further upside. The bank sector currently offers a 4.0% yield into FY21E, increasing to 5.0% FY22E.

On a macroeconomic basis, we believe that a broader economic recovery is likely to be beneficial for the banks. Falling unemployment and a higher level of economic activity going into CY21 should improve investor confidence in the banks' bad debts and future earnings expectations.

We believe that the banks' bad debts could be overstated, and these provisions could be unwound over the next calendar year boosting earnings growth and dividend potential. The provisions were put in place when higher unemployment and defaults were more probable; these provisions seemed prudent at the time. After the VIC reopening, we believe there is a risk to the upside for future economic data compared to consensus, and these provisions will look too strong.

With a clearer outlook, APRA is more likely to start easing its capital management guidance on payout ratios, which currently sit at 50%. Higher dividends coupled with a broader earnings recovery in FY21 should be tailwinds for the banks, and we therefore remain overweight.

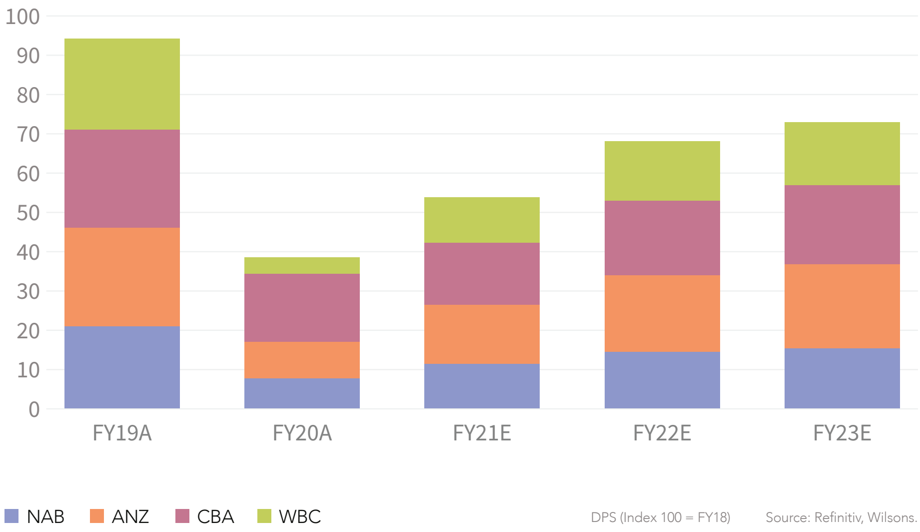
BHP Group (BHP) - 10% weight

BHP outperformed the market until August as China rebounded from the COVID-19 pandemic and the iron ore price recovered. Since then, the stock has underperformed as the market became more cautious on the 2021 iron ore price prospects and as Australian-China trade tensions started to escalate. This changed at the beginning of November.

BHP is now at record highs. Two catalysts have driven the share price to this position. Firstly, vaccine news supported iron ore prices with optimism surrounding a global economic recovery. Secondly, Vale reduced its 2020 and 2021 iron ore output forecast by ~5%, and the iron ore price rallied to ~A$145, the highest it has been since 2013. With global industrial production likely in recovery mode through 2021, BHP provides large diversified exposure to this theme.

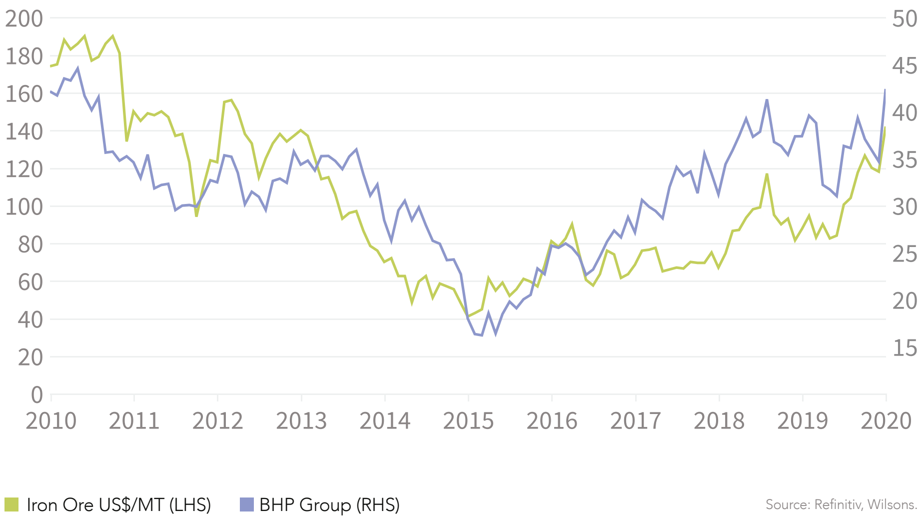
Looking into CY21, we believe there will be further upgrades to the iron ore price as demand from China remains undeterred even with current tensions, and as Brazilian supply weakens. Any upgrades to iron ore should support BHP's price. BHP also offers upside via its copper (20% Group) and energy divisions (10% of Group).

Exhibit 13: Bank dividends could materially increase in FY21/22E



DPS (Index 100 = FY18) Source: Refinitiv, Wilsons.

Exhibit 14: Rising Fe price has helped BHP share price performance



Source: Refinitiv, Wilsons.

Exhibit 15: Focus List Valuation Metrics

Ticker	Name	Sector	Focus List Weight	EPS CAGR (FY21-FY23)	PE (FY21)	Div Yield (FY21)	ROE (FY21)
Asset Valuation Plays							
AVN	Aventus	Real Estate	4.0%	5%	14.5	6.1%	7.7
NWS	News Corporation	Communication Services	2.0%	42%	59.2	0.8%	2.4
Cyclical Quality Growth							
ALL	Aristocrat Leisure	Consumer Discretionary	3.5%	26%	28.7	1.5%	20.3
WOR	Worley	Energy	3.0%	15%	18.4	3.5%	5.8
BHP	BHP Group	Materials	10.0%	-8%	13.3	3.7%	22.0
CBA	CBA	Financials	7.0%	8%	20.1	3.3%	9.9
JHX	James Hardie Industries	Materials	3.0%	14%	29.0	0.9%	30.9
MQG	Macquarie Group	Financials	6.0%	24%	24.0	2.5%	10.4
Cyclical Value							
ANZ	ANZ	Financials	7.0%	9%	14.2	4.1%	7.7
OZL	OZ Minerals Limited	Materials	3.0%	41%	32.5	1.1%	6.4
NAB	NAB	Financials	5.0%	9%	18.1	3.8%	7.9
RWC	Reliance	Industrials	3.0%	9%	20.6	2.3%	10.8
STO	Santos Limited	Energy	4.0%	42%	31.0	0.8%	5.0
SUL	Super Retail	Consumer Discretionary	3.0%	-4%	11.5	5.4%	18.6
SVW	Seven Group Holdings	Industrials	4.0%	11%	17.4	2.0%	14.4
Defensive Growth							
AZJ	Aurizon Holdings	Industrials	3.0%	9%	16.3	6.1%	11.7
NST	Northern Star Resources	Materials	3.0%	16%	15.4	1.7%	25.3
TCL	Transurban Group	Industrials	4.0%	17%	-	2.8%	-0.7
Secular Growth							
APX	Appen	Information Technology	3.0%	33%	49.9	0.4%	14.1
CSL	CSL	Healthcare	7.0%	12%	44.8	0.7%	31.3
GMG	Goodman Group	Real Estate	3.0%	10%	29.0	1.6%	10.5
RMD	ResMed	Healthcare	2.0%	10%	41.4	0.6%	27.1
TLX	Telix Pharmaceuticals	Healthcare	2.0%	-	-	0.0%	1.0
XRO	Xero Limited	Information Technology	3.5%	52%	-	0.0%	12.7
EML	EML Payments	Information Technology	2.0%	35%	40.0	0.0%	6.5

Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

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

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