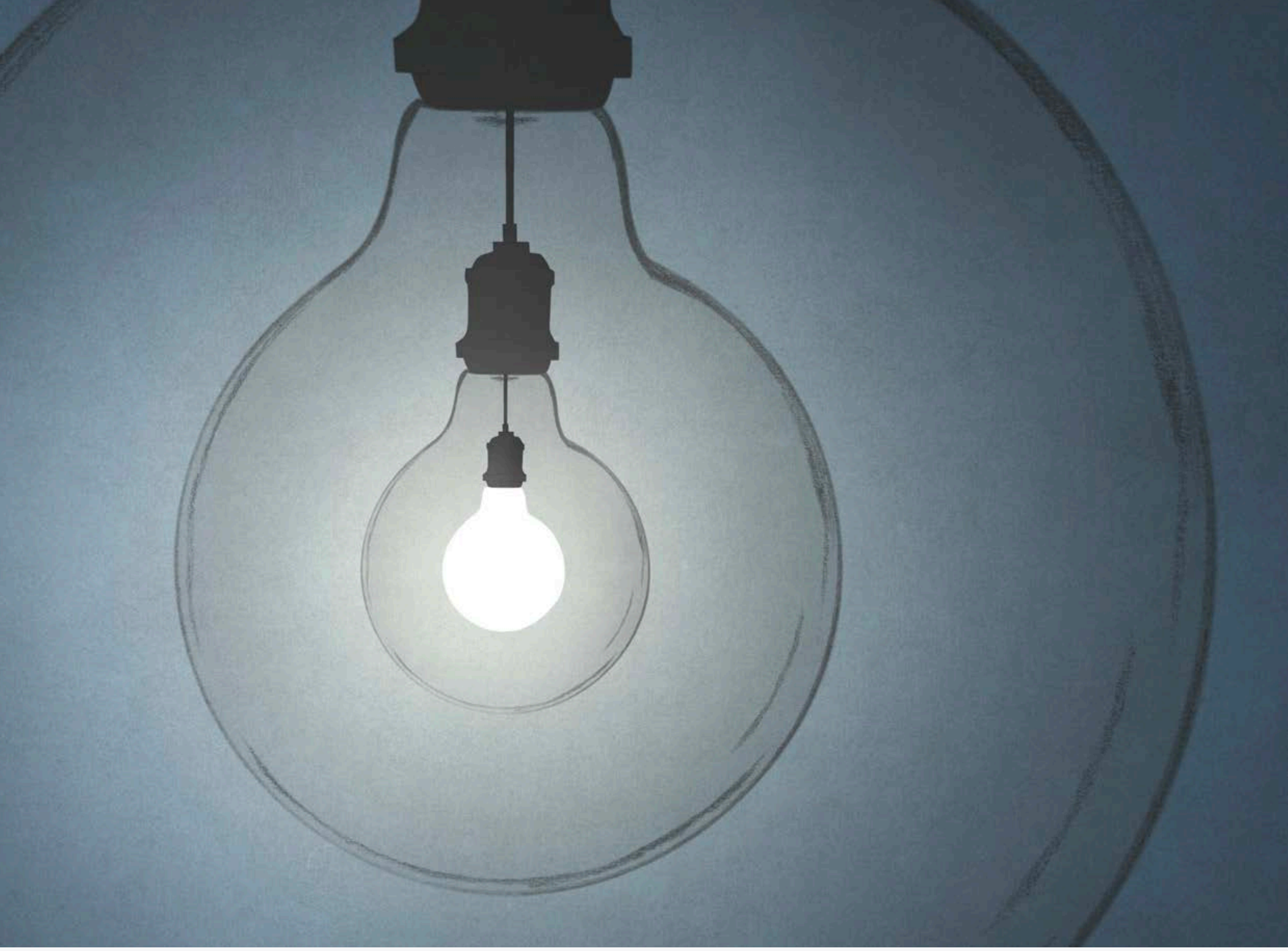


Can Australia's Earnings Reflect the Improving Outlook?

Our weekly view on Australian equities.

29 January 2021

The Key Question for Investors

The key question for investors ahead of the February reporting season is whether the improving outlook is appropriately priced, with the market at 20x FY21E earnings.

Delving into the current economic backdrop, we look at the macro themes expected to influence the reporting season and their impact on the companies in the Wilsons Australian Equity Focus List.

Reporting Season Backdrop

Price action in the lead up to the reporting season has been strong. The S&P/ASX 200 market has risen almost 15% in the 6 months since the August result season, with the bulk of that happening after November as positive vaccine news began to break.

The good news on the price front is that market earnings upgrades have accompanied rising share prices. The upgrades have been broad-based and across FY20 and FY21 earnings.

In the 3 months since October, market earnings for FY20 have risen by more than 3% points. For FY21, earnings growth has been upgraded from 13% to almost 15%, led by the materials sector (+6.6% earnings upgrade), communication services (+3.5%) and consumer discretionary (+3.7%).

We have also seen a raft of consumer retailer earnings upgrades throughout January which further support our view that earnings at market level are likely to remain in upgrade mode through the upcoming results season. This could help close the relative performance gap that has emerged over the past 9 months between Australia and global equities (MSCI World Index).

4 Influences Shaping Reporting Season

We see 4 main influences on results season that investors should watch:

1. Earnings expectations remain too low

As we have previously flagged, we think the market is underestimating the return of earnings driven by:

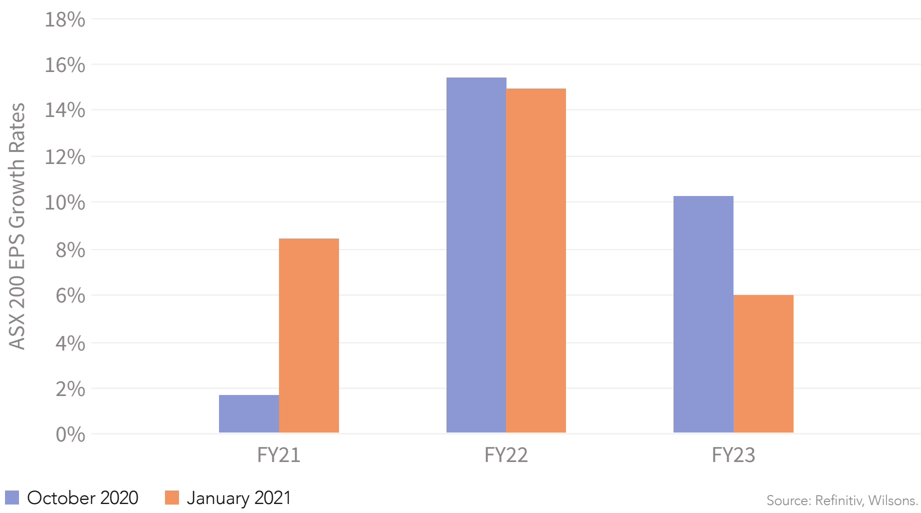
a. A strong health outcome in Australia allowing a faster than anticipated recovery in economic activity coupled with large stimulus measures and;

b. A low base effect potentially allowing lagging Australian corporate earnings greater recovery headroom as the post-COVID-19 cycle takes hold.

Market earnings have been in upgrade mode since the end of the previous result season, with miners, energy and retailers most notable for earnings upgrades over the past 3 months.

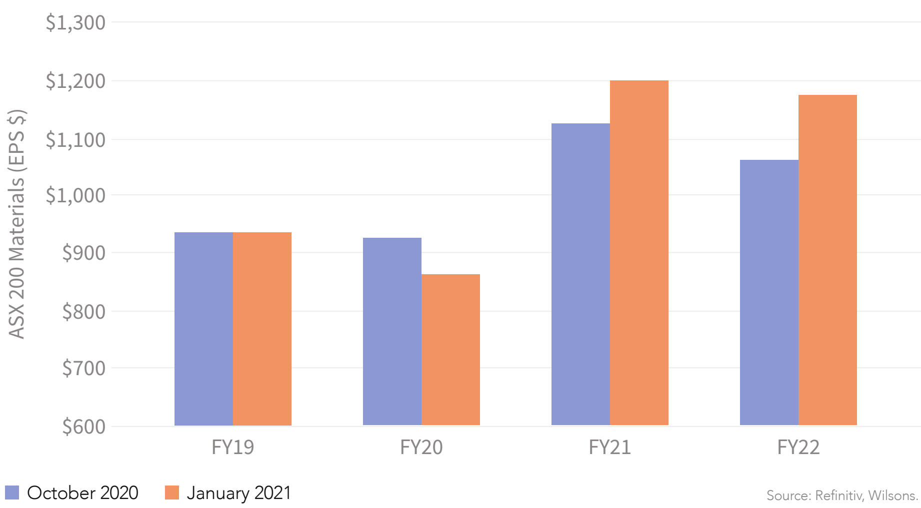
We also expect stronger margins and cash generation to feature across the board thanks to cost-out actions taken early in the pandemic and stronger than expected revenue. This is likely to allow for inventories to have been drawn down.

Exhibit 1: Market earnings upgrades for FY21 particularly strong since October



Source: Refinitiv, Wilsons.
Market EPS growth (%) rate June adjusted.

Exhibit 2: Materials sector has seen particularly strong earnings upgrades



Source: Refinitiv, Wilsons.
Materials sector indexed EPS.

2. Domestic focus strength

The redirection of spending due to the closure of international borders, domestic travel restrictions and social distancing requirements should see strong results from the stay-at-home beneficiaries.

Discretionary and non-discretionary retailers should benefit from this trend. Likewise, housing-related names - James Hardie Industries (JHX), Reliance Worldwide Corporation (RWC), and Super Retail Group (SUL) - should also benefit, with more households investing in their own homes during the pandemic.

For the retailers, investor attention will primarily be around trading updates given pre-announced earnings for many discretionary retailers - Super Retail Group (SUL). Here investors will be asking, 'have these boom-time conditions persisted into 2021?', and 'what is the outlook for the remainder of 2021?'.

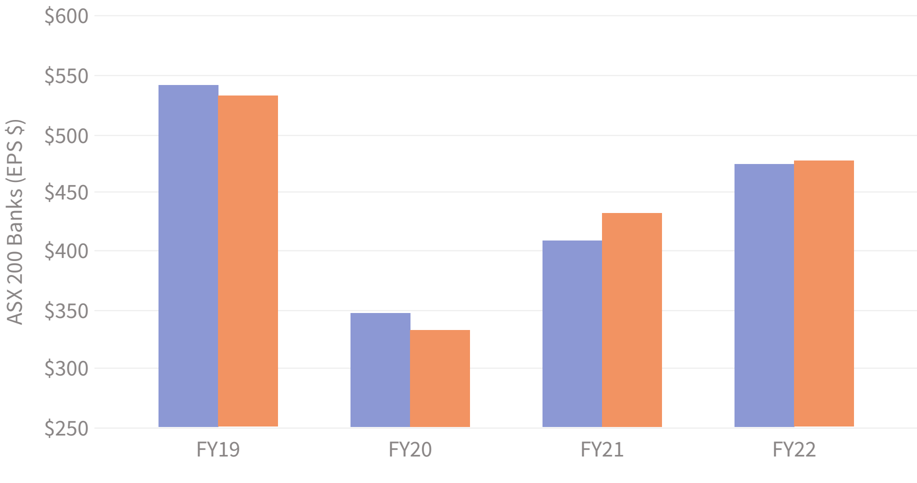
We suspect that the market is still underestimating how long these conditions will last for and expect a slow and gradual return to normal, despite the benefit of the local vaccine rollout and the likely long-dated international border reopening process.

The banks look poised to begin a cycle of above-market results - Commonwealth Bank (CBA) and National Australia Bank (NAB). We have seen this with US banks already at their recent results, earnings beats and bad debt-provision write-backs.

We think the banks will benefit from:

- Lower bad-debts
- Provision reversals
- Early signs of increased demand for credit
- Stronger than expected dividends (APRA loosened the dividend restrictions in December 2021)

Exhibit 3: Bank sector has seen EPS revisions for FY21 with the improving macro environment



Source: Refinitiv, Wilsons.

3. Dividend resumption and surprise

The banks are not alone. Thanks to buoyant commodities prices, the resources and energy sectors are also likely to show dividend surprises. BHP Group (BHP), OZ Minerals (OZL), Northern Star Resources (NST) and Santos (STO) all have the capacity for dividend per share (DPS) surprising following a period of strong pricing, cost control and healthy production levels.

4. Reluctant guidance

We will not be surprised if the level of earnings guidance remains below traditional levels. The operating environment still contains range uncertainties that are likely to weigh on considerations around providing guidance, with the return of domestic lockdowns over Dec/Jan being a great example of still uncertain operating conditions.

With 5 months to go until the FY21 balance date, some companies are likely to be better positioned to provide guidance. EML Payments (EML), Super Retail Group (SUL) and Seven Group Holdings (SVW) all intend to give FY21 guidance for the first time. Others like Reliance Worldwide Corporation (RWC) still believe the outlook is too uncertain – despite posting its second upgrade for FY21 in 6 months in a pre-announced earnings release this week.

The rising AU$/US$ is unlikely to be an issue for actual results given most of the currency move happened late in 2H20, but we do think offshore earners could potentially face currency headwinds. Appen (APX), EML Payments (EML), Reliance Worldwide Corporation (RWC), Worley (WOR) and healthcare names all have some vulnerability.

Read our first quarter asset allocation strategy - A Recovery Worth Waiting For.

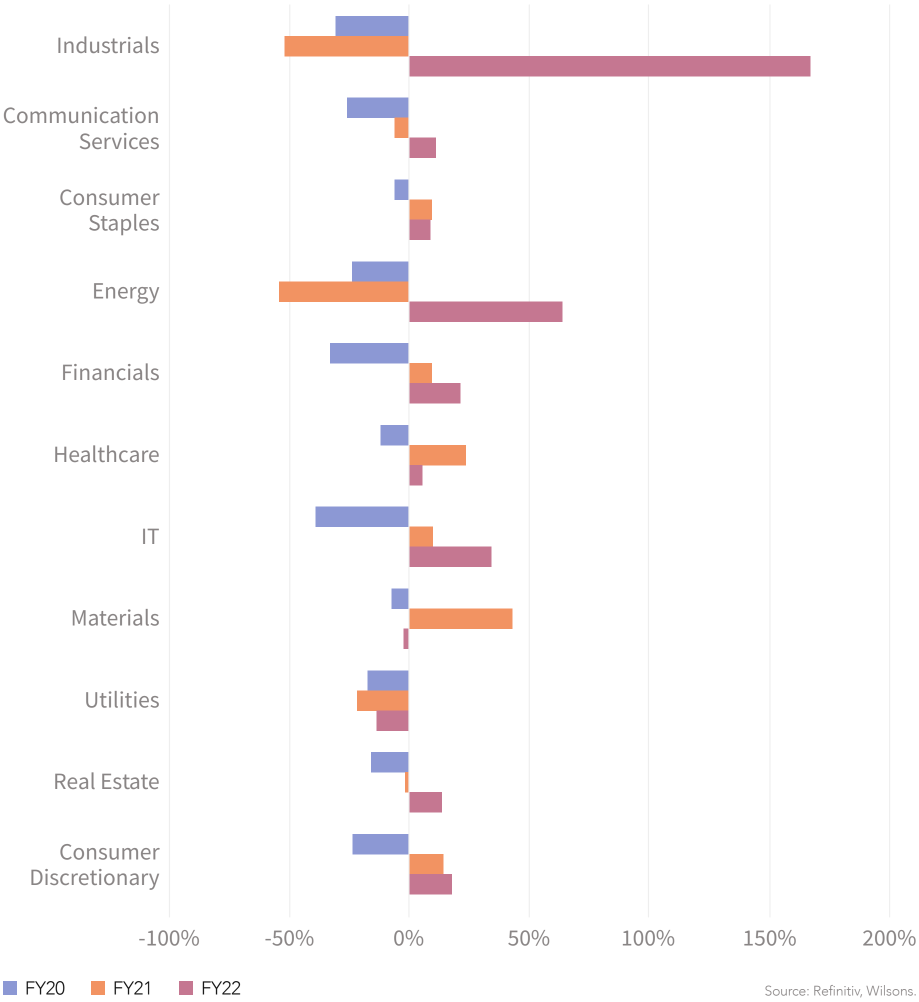
The Outlook for this Season and Beyond

The S&P/ASX 200 index over the past 10 reporting seasons back to 2016 has been evenly split at 5 all between result periods that have seen index gains versus periods with index losses.

We think the outlook for this February remains positively skewed to the upside given earnings upgrade potential and Australian index underperformance over the past 9 months. If the currency rally in the AU$ begins to fade (or reverse) this would increase the likelihood of the index gaining ground through the reporting season.

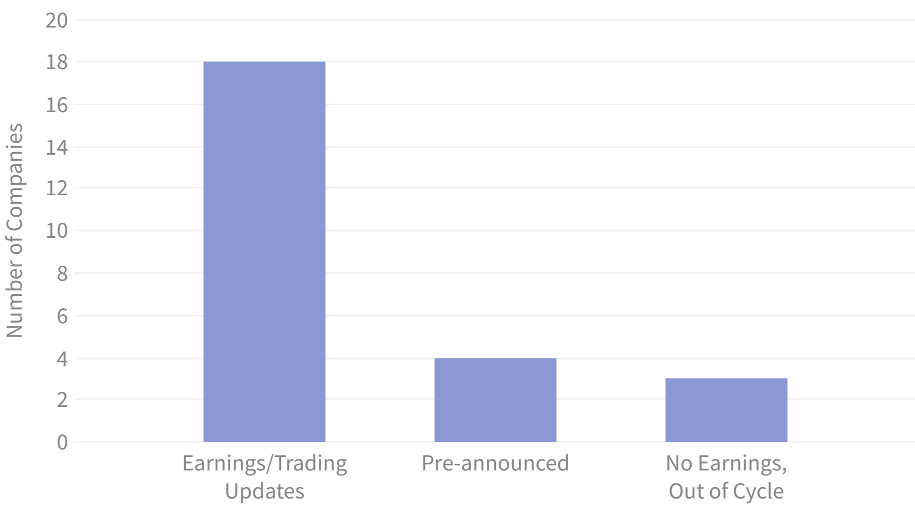
Looking beyond the immediate reporting season, investors should remain focused on the earnings improvement story as economies and corporate earnings emerge from COVID-19. In FY20 all 11 sectors reported falls in earnings. In FY21, 6/11 sectors are forecast to post earnings growth, increasing to 9/11 sectors in FY22 as the recovery takes hold. This remains the bigger picture for investors over the coming 12-18 months.

Exhibit 4: Sector EPS growth expectations



Source: Refinitiv, Wilsons.

Exhibit 5: Focus List reporting season



Source: Refinitiv,.

Australian Equity Focus List Result Preview

Potential result reaction: Upgrade Neutral Downgrade

Ticker	Company	Result Period	Date	Consensus EPS (for period)*	Comment
RMD	ResMed	2Q21	28/01/2021	1.26	Market is looking for 2Q21 EPS $US1.26 equating to +6% yoy growth. Both devices and masks are likely to show incremental growth given recent peer commentary around COVID-19 impacts. FY21 is a year of earnings deceleration for RMD - after the +30% in FY20, just +8% in expected in FY21E. Stock price will be sensitive to perceived changes in the forward growth rates given high PER multiple.
NWS	News Corporation	1H21	05/02/2021	0.10	1Q21 earnings in December led to +20% EBITDA upgrades for FY21E. We expect the positive operating trends to have continued into 2Q21 - particularly within advertising and real estate businesses. Any update on further strategic repositioning of NWS assets would be well received given the large valuation disconnect between NWS share price and implied value of REA in particular.
MQG	Macquarie Group	Trading Update	09/02/2021	N/A	Outlook comments and potential for deal flow and reduction in provisions will be important for investors. Earnings expected to be lower than FY20 but have been protected by strong equity and asset prices.
JHX	James Hardie	3Q21	09/02/2021	0.24	US homebuilding continues to be strong. Earnings likely to be slightly lower than previous quarter for seasonal reasons, but still expected to be 41% higher pcp. Result needs to be in line with consensus to reflect PE expansion in 2020.
CBA	CBA	1H21	10/02/2021	2.06	Earnings recovery expected after a broader reopening of the economy in the 2nd half of last year. Dividends and provision reversals will be key. APRA has scrapped its previous ruling on dividend caps so there is an expectation that dividend yields will increase substantially. An improving housing sector and economy should provide enough evidence for CBA to reverse a proportion of its bad debt provisions, however the banking sector is likely to remain prudent until vaccinations are in full swing.
NST	Northern Star	1H21	11/02/2021	0.29	There is potential for an upgrade from NST with production at the top end of the guidance range in December. Information on the Saracen merger will be of interest after the 2nd court date to finalise the merger on the 02/02/2021. Balance sheet could look stronger with a reduction in debt and strong cashflow in 2020.
TCL	Transurban	1H21	11/02/2021	0.15	Dividend already announced this month (15cps), so less surprises expected at results. Earnings are anticipated to be slighly better than 2H20 (in EBITDA) as the return to office thematic continues. Potential for an announcement for a capital raising to be used on a transaction in the US.
CSL	CSL	1H21	12/02/2021	3.01	Recent data (in December) showed a slowdown in the plasma collection recovery for CSL which may provide an upset in the half year results. Investors are likely to remain focused on the next 12 months rather than the previous 12 as the company could be classified as a global reopening beneficiary.
BHP	BHP Group	1H21	15/02/2021	1.20	The increase in iron ore prices and production in 1H21 has led to strong optimism on the earnings results, which has flowed through to the price. Dividends will be of interest, potential for a special dividend to be announced.
AZJ	Aurizon	1H21	15/02/2021	0.13	Coal haulage guidance volumes of 210-220Mt - potetenital downside risk given COVID-19 and Chinese import quotas; FY21 earnings guidance for u/l EBIT $830-880m (-3-9% on pcp) likely to be tightened; capital management - 100% DPS payout, current buyback almost complete; but could expanded following $130m Acacia Ridge sale and further $1.2bn from capital restructure.
OZL	Oz Minerals	FY20	16/02/2021	0.60	Could surprise with higher 2H DPS following strong production in 2H20. Further updates on growing existing and pipeline assets.
NAB	NAB	1Q21 Trading Update	16/02/2021	N/A	Banks - credit growth should beat expectations with a stronger than expected economic recovery. Resumption of dividends should provide confidence.
SVW	Seven Group	1H21	17/02/2021	0.68	No guidance, but has flagged potential for FY21 guidance at Result. 1) Westrac - high single digit earnings growth; 2) Coates - low single digit earnings growth; 3) Energy and media earnings less certain; 4) Market looking for flat EBITDA growth in FY21E.
SUL	Super Retail	1H21	18/02/2021	0.78	Result pre-announced. Focus will be on trading update for Jan, Feb MTD (we expect ~20% LFL given bushfire impacted comp and strong domestic demand); cash generation expected to be strong/dividend surprise and; outlook comments for 2H21. We still think the market is underestimating the duration of strong sales period, particularly given low expectations around a return to international travel in 2021.
STO	Santos	FY20	18/02/2021	0.17	Santos 4Q20 production benefited from higher volumes, lower production costs and lower revenue (LNG prices). With 2021 CAPEX and production guidance already given, we look for updates on the timing of new project developments (FID Barossa + FEED Dorado), and capital position ahead of CAPEX (asset sell-downs).
GMG	Goodman Group	1H21	19/02/2021	0.30	Look for upgrade to FY21E guidance (+9% earnings growth) driven by higher management earnings, higher development earnings, higher performance fees. Outlook comments surrounding new business levels expected to remain very strong.

* DPS used for TCL

Potential result reaction: Upgrade Neutral Downgrade

Ticker	Company	Result Period	Date	Consensus EPS (for period)*	Comment
RWC	Reliance	1H21	22/02/2021	1.04	Result pre-announced, 1H21 EBITDA $164-$167m +17% ahead of market. Key issues: upside risk to 5cps DPS given earnings and cash generation, future growth opportunities given unexpected deleveraging of balance sheet, outlook comments around expected strength of demand/rising copper prices/AU$/US$ rise.
EML	EML Payments	1H21	22/02/2021	0.04	FY21 EBITDA guidance will be the focus. Market has wide range from high $40m to low $60m - with variance primarily driven by Gift Cards & Incentive performance. Given tighter lockdown restrictions in Nov/Dec selling period there is some risk this number is soft. Other focus points: balance sheet is strong net cash - any update on plans for that, performance of the Pre-paid Financial Services acquisition, update on new contract wins.
WOR	Worley	1H21	22/02/2021	0.33	No guidance. Dec update flagged further headcount reductions (-17% Oct 2020 versus pre-COVID-19), COVID-19 site access restrictions, and AU$ headwinds. Market is looking for FY21 EBITDA to fall -4%. Areas to watch: potential for EBITDA margin surprise given head count reduction, comments around new business outlook, synergy/cost out benefits following ECR acquisition.
APX	Appen	FY20	24/02/2021	0.49	Downgrade result pre-announced in Dec. 20. Key Issues: margins and cash generation, FY21 outlook comments likely - given increased COVID restrictions in US over Dec/Jan, risks are likely skewed to the downside. APX has talked about being about to grow revenue at industry growth rates of ~28% (APX consensus 18% for FY21E), whether rising AU$/US$ weighs on guidance.
AVN	Aventus Group	1H21	25/02/2021	0.09	Guidance of at least 18.5cps FFO expected to be maintained. 4Q dividend was slighty ahead of expectations suggesting the business is performing well. Look for updates on occupancy and rent collection, development pipeline progress, potential move into funds management, and asset revaluation upside given cap rate of 6.7% looks on the high side.
ALL	Aristocrat Leisure	AGM	26/02/2021	N/A	Trading update traditionally given at AGM. ALL does not have guidance for FY21. ALL digital business appears to have strong revenue performance across Nov/Dec 20 with revenue growth of 35-40% yoy.
TLX	Telix	FY20	TBC	-0.05	The earnings release is unlikely to be the focus for investors. Commentary around new catalysts would be more of interest, specifically market apprrovals of the TLX591-CDx prostate cancer imaging product and the ZIRCON trial results.
ANZ	ANZ	N/A	05/05/2021	N/A	No update expected, but drivers consistent with the other Big 4 Banks - provision reversals and resumption of dividends should be positive catalysts.
XRO	Xero	N/A	13/05/2021	0.13	XRO typically provides limited updates between result periods. Large global TAM, growing revenue >20%, and increasing operating leverage suggest XRO is still a market outperformer.

* DPS used for TCL

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Recommendation structure and other definitions

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

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