WILSONS

February Reporting Season: The Bounce Back

Our weekly view on Australian equities.

18 February 2021

Beating Estimates at the Halfway Mark

As we approach the halfway point of the February reporting season, the clear trend emerging is that corporate Australia has bounced back strongly over the second half of CY20, with the improving domestic economy translating into improved earnings and dividends.

Domestic consumer discretionary businesses have done well and global businesses exposed to either commodities or housing have also posted solid results. We estimate around half of all results are beating market estimates, compared to around one-third in August 2020.

The Earnings Picture

Earnings for the market remain in upgrade mode, with 3 distinct factors driving earnings upgrades:

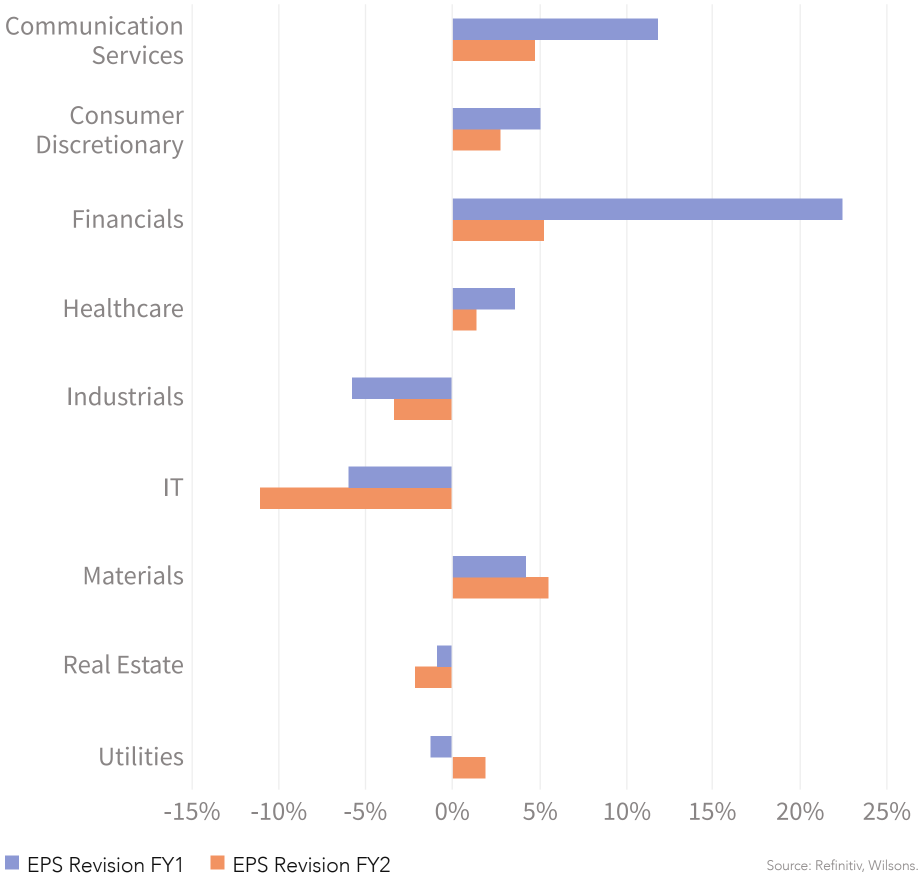
1. Low base effect due to COVID-19 impacts
2. Conservative market expectations
3. Australian earnings pre-COVID-19 were not particularly high relative to prior cycles

Read Can Australia's Earnings Reflect the Improving Outlook and Australian Recovery to Gather Strength into 2021.

Earnings revisions for S&P/ASX 200 across the next 3 years have remained positive: +3%, +2.5% and +1.3% across FY21E, FY22E and FY23E respectively over the past month. That leaves annualised growth for the market now at +12% for FY21E, +14% for FY22E and +4% FY23E.

The fade in earnings growth has been pushed from FY22E into FY23E. And as we have flagged previously, there are large implied earnings upgrades for materials if we assume spot commodity prices hold.

Exhibit 1: 1-month earnings revision is positive across most sectors



Source: Refinitiv, Wilsons.

In financials, a pickup in lending volumes or share buybacks across the major banks are currently underappreciated in current earnings estimates. If both these events play out, FY23E earnings will be vulnerable to further upward revisions.

Most sectors are seeing earnings upgrades, which is encouraging from a market breadth perspective. Financials - Commonwealth Bank (CBA), Bendigo and Adelaide Bank (BEN), Insurance Australia Group (IAG) and Suncorp Group (SUN) - and materials (across the board) lead the way in FY22.

Both consumer discretionary and communications services are also seeing upgrades. Technology earnings have downgraded due to Altium Limited (ALU) and Megaport (MP1), and industrials due to CIMIC Group (CIM) Downer Group (DOW) and Transurban Group (TCL).

The larger earnings misses at this point have mostly come from companies that had challenges before COVID-19 – AGL Energy (AGL), AMP (AMP), Boral (BLD), CIMIC Group (CIM), Challenger (CGF), Telstra Corporation (TLS) and Unibail-Rodamco-Westfield (URW).

An Improving Dividend Outlook

The improved outlook has seen the number of companies delivering dividend surprises outnumber companies beating on earnings.

Payout ratios have been lifted by companies considered COVID-19 winners, such as materials and consumer discretionary.

Financials have seen higher dividend payouts after APRA restrictions were removed, and strong capital positions. Companies are using higher dividend payouts rather than special dividends or share buybacks to return excess cash.

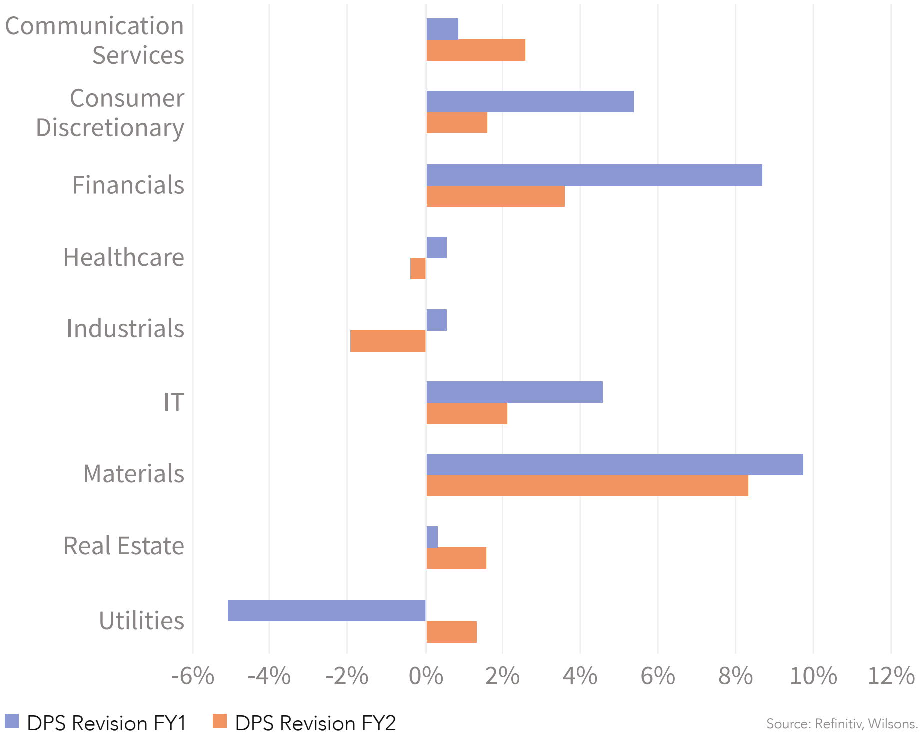
Several companies have resumed dividends, often earlier than what the market was thinking - James Hardie Industries (JHX) and Sims Metal Management (SGM).

Looking forward, large positive dividend revisions have been seen across financials and materials, and we are starting to see the market contemplate large share buybacks for the major banks. The market is now looking at the potential for ~$10bn (~6% of equity capital) share buyback at the August results for Commonwealth Bank (CBA).

COVID-19 Losers Seeing Stronger Price Performance

Result day price reaction in the Australian market can often dictate a company's relative performance over the following 3 months.

Exhibit 2: 1-month dividend revision is positive across most sectors



Source: Refinitiv, Wilsons.

A result day price move both up, and above market, often leads to further near-term outperformance as improving sentiment/earnings lift the share price. The opposite also holds.

Splitting the companies that have reported into two groups - the COVID-19 winners and losers in terms of business performance and share price versus 2019 - the losers are having the stronger share price action.

This is not completely surprising given the market is looking to buy cyclical recovery companies, as well as optimism about the outlook and strong share price moves we have seen in many of the winners. The Wilsons Australian Equity Focus List is heavily skewed towards cyclical recovery companies at present given our view on the recovery outlook and prospect for cyclical recovery.

S&P/ASX 100 price reaction: COVID-19 losers are seeing higher positive performance (relative change on day)

0.2%	-0.1%
Loser	**Winner**

Source: Refinitiv, Wilsons.
Simple average across S&P/ASX 100 result up to 16 Feb. 21.

Exhibit 4: S&P/ASX 100 Result Season Snapshot

Attribute	Number	%	Companies
Stock Relative Performance (on day of results) >3%	6	21%	JBH, AZJ, NCM, AMC, IAG, BEN
Profit Beat >5%	13	45%	IAG, NCM, TLS, SUN, JHX, BHP, RMD, MGR, BLD, REA, BEN, GPT
EPS Upgrade >5%	9	31%	IAG, JBH, ANN, BLD, SUN, BHP
DPS Upgrade >5%	11	38%	JHX, IAG, DOW, JBH, SUN, NCM, CBA, CPU, BHP, ANN
Stock Relative Performance (on day of result) <3%	5	21%	CGF, AMP, BLD, ALU, MFG
Profit Miss <-5%	6	21%	ALU, DOW, AMP, IGO, BLD, AGL
EPS Downgrade <-5%	3	10%	DOW, IGO
DPS Downgrade <-5%	5	17%	IGO, AMP, BLD, RMD

Source: Refinitiv, Wilsons.

4 Key Trends

1

Retail discretionary spending remains elevated

Strong results from discretionary retailers were flagged with several earnings pre-announcements. The new information on result day primarily focused on comments around trading conditions for 2021. Almost without exception, buoyant trading conditions have been maintained into early 2021, with the re-emergence of lockdowns and the at home consumption trend enduring.

There remains a level of uncertainty as to how long these conditions will last – both from companies and investors. JB Hi-Fi (JBH) is not prepared to give guidance, despite having a healthy operating environment, and this is reflected across the discretionary sector.

Investors have been reluctant to push the share prices of the discretionary retailers higher out of fear that consumption is simply being brought forward. The FY21 upgrade becomes the FY22 upgrade against a backdrop of peak earnings as post-COVID-19 life normalises.

While domestic goods consumption is likely to be buoyant through 2021, the market will not be willing to factor this into share prices until there is further evidence of the consumption cycle extending. This makes trading updates in March/April increasingly important.

2

New cost cut programs

For some companies, the cyclical recovery is not enough to lift earnings and meet return targets, with new efficiency programs announced for AGL Energy (AGL), Boral (BLD) and Suncorp group (SUN).

All three companies have assets spread across many sub-sectors of their industries, which has resulted in a lack of focus and reduction in returns on capital. The new programs are designed to accelerate the pace at which these companies can resume respectable rates of return on their capital. This makes trading updates in March/April increasingly important.

3

Company transformation programs accelerated

Major crises tend to accelerate trends already in place, and COVID-19 is proving to be no different. While some businesses have responded by ramping up company transformation programs, others have been too slow to adapt or respond to the threats endangering future operating cash flows.

AGL Energy (AGL) is a clear example of this. Long on hydro-carbon energy generation/distribution, its earnings base is under threat. While the company has taken a significant write-down of coal-fired power station assets alongside a comprehensive strategic review, it is still unclear where future earnings will come from. With some within AGL suggesting a break up may be the way forward, there are sizeable strategic questions that remain unanswered. Earnings remain in a downgrade cycle, with the likelihood of dividends halving into FY23E. This suggests the risk-reward balance remains unfavourable in our view.

Aurizon Holdings (AZJ), Commonwealth Bank (CBA), Insurance Australia Group (IAG), Suncorp Group (SUN) and Telstra Corporation (TLS) have all accelerated their company transformation programs. For these businesses, the risks of lost cash flow generation are not as pronounced as for AGL, but all have rising strategic risks due to the threat of disruption forcing companies to accelerate their change agenda.

Commonwealth Bank (CBA, Focus List member) is looking to build on its technology leadership versus peers, while Insurance Australia Group (IAG) and Suncorp Group (SUN) are looking to change how customers interact with the business to drive efficiency gains. Telstra (TLS) is looking to potentially break itself up as a way of releasing shareholder value. Aurizon Holdings (AZJ), which has heavy exposure to coal volumes it has no control over, has announced another small acquisition and flagged additional new acquisitions to pivot the business away from coal dependency while trying to lift earnings growth.

4

Global housing upcycle

One of the strongest themes to emerge from results season is the strength in global housing activity – construction, renovation and turnover against a backdrop of rising house prices.

James Hardie (JHX, Focus List member) pointed to an acceleration in demand for its products after producing a large earnings beat. Reliance Worldwide (RWC, Focus List Member) pre-announced earnings well ahead of the market as demand for plumbing products emains elevated.

News Corp (NWS, Focus List member) which owns part of Real Estate Group (REA) spoke to increased housing turnover, while its US-owned real estate portal MOVE posted its strongest earnings numbers on record.

Fed by a combination of low interest rates, rising employment levels and desire from families to "make home great", we think the global housing cycle is only just in its infancy. The Focus List is overweight housing exposed names.

Key Company Comments

Focus List

AGL Energy (AGL)

"AGL is actively assessing our business model and capital structure to maximise shareholder value and support our evolving strategy as the shaping forces of customer needs, community expectations and technology continue to accelerate."

CEO, Brett Redman

Aurizon Holdings (AZJ)

"What we're starting to see, as evidenced by our acquisition of ConPorts and TBSH, are some opportunities in the bulk market. We can see some further opportunities going forward. So we'll consider those vis-à-vis capital management each progressive year…and it will be a matter for the Board how we pursue further capital management."

CFO & Group Executive Strategy, George Lippiatt

Telstra Corporation (TLS)

"On the sale of towers business, I think you can assume that we will look at the full sort of spectrum of options available to us, partly around strengthening the balance sheet, partly around investing in the future and partly around returning value to shareholders as well."

CEO, MD & Director, Andrew Penn

Focus List

Transurban Group (TCL)

"When you deal with our network and traffic modelers and forecasters and the economics and all the specials we have in there, they just talk about this as noise around a 50- or 60-year profile."

CEO & Executive Director, Scott Charlton

Brambles (BXB)

"While there is still uncertainty about customer demand patterns over the balance of the year, we expect year-on-year revenue growth to moderate in the year following the initial COVID-19 outbreak in our major markets."

CEO, Graham Chipchase

Focus List

James Hardie Industries (JHX)

"Our business accelerated considerably during our fiscal 3rd quarter, marking the 7th consecutive quarter that our global team has delivered growth above the market with strong returns."

CEO, Dr. Jack Truong

JB HI-FI (JBH)

"We are really pleased with the strong sales momentum that's continuing into January across all our brands. Whilst we are pleased with the start to the second half, in view of the ongoing uncertainty arriving from COVID-19, the group does not currently consider appropriate broad sales and earnings guidance."

CEO, Richard Murray

Focus List

REA Group (REA)

"In Australia, the residential market had a very strong finish to the year. National residential listings increased 4% for the half, driven by the easing of COVID restrictions, combined with increasing consumer confidence, record low interest rates and healthy bank liquidity."

CEO, Owen Wilson

Focus List

Commonwealth Bank (CBA)

"Home lending, both fundings but also approvals, have continued to grow strongly during the period…December was a strong month. And as we look at January, certainly versus the prior corresponding period, it was again a strong month of applications."

CEO, Matthew Comyn

Focus List

BHP Group (BHP)

"Our business performance is strong, our strategy is intact and advancing, and the outlook for commodities is promising."

CEO & Executive Director, Mike Henry

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Recommendation structure and other definitions

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

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