WILSONS

Higher Conviction in the Cycle

Our weekly view on Australian equities.

25 February 2021

3 Big Reporting Season Trends

Reporting season continues to play out as we predicted in late January, defined by 3 major trends:

1. Earnings upgrades to FY21 and FY22 market earnings
2. Higher dividends with financial and material sectors leading the way
3. Strong cash generation leaving leverage ratios well placed in general

Read our January predictions - Can Australia's Earnings reflect the Improving Outlook?

While earnings and dividends have been negatively impacted for the market as a whole - both down on the previous corresponding period (PCP) - this results season has been well-received relative to expectations. Earnings and dividend upgrades across FY21E–FY23E have helped reinforce the theme that a multi-year cyclical expansion is now more probable.

Importantly, the pathway to improved earnings is becoming clearer with the pace of the global vaccine rollout, which now includes Australia, firming our view. This should help lessen the likelihood of a third-wave domestic lockdown, and give investors a clearer path to an earnings recovery.

Repositioning the Australian Equity Focus List

Against this backdrop, we have repositioned the Wilsons Australian Equity Focus List in response to reporting season trends.

We have increased our exposure to the banks following upbeat earnings and trading updates. Banks have recouped less than 25% of their relative underperformance versus the market since 2015 when back share prices peaked.

Both earnings and dividends can improve through an economic recovery, and we think the market is underestimating the potential for volume and revenue growth to support earnings.

Capital management opportunities are increasing given strong capital positions. We are now 1.2x overweight the bank sector, with a preference for the cheaper banks of ANZ (ANZ), National Australia Bank (NAB) and Westpac (WBC). Commonwealth Bank (CBA) departs the Focus List following a period of strong outperformance.

We increased exposure to Worley (WOR) on the firm view that earnings have bottomed at ~50% below pre-COVID-19 levels. We believe that a materially higher dividend provides strong signalling that WOR believes the cycle has turned. The business pivot to non-hydrocarbon work is intensifying, which could provide a high-growth pathway for many years – something that the share price is currently not factoring in.

CSL Limited (CSL) has been downweighted for the second time since news of the COVID-19 vaccine broke.

We think the next 6-12 months presents a potentially difficult setup for CSL, with competing forces around higher costs and potential lack of inventory squashing earnings growth, and CSL's flu business unlikely to deliver a repeat performance of 1HFY21. The market is likely to debate these competing forces over 2021, presenting an unhelpful backdrop to outperformance in our view. We are now underweight CSL at 0.7x market weight.

Small Cost to Quality for Cyclical Exposure

The increased exposure to cyclical earnings does come at a small overall cost to quality for the Focus List – return on equity (ROE) falls from 14.3% to 13.5%. Earnings growth remains unchanged at 10% compound annual growth rate (CAGR) over the next 3 years, although we would argue the market underestimates the earnings recovery. The further push into cyclical exposures is only possible given the constructive backdrop being driven by the reopening, stimulus and operating leverage for the companies we have selected.

Exhibit 1: Focus List changes

Name	Focus List Weight Old	Focus List Weight New	ASX 200 Weight	Index Relative
WOR	3.0%	4.0%	0.3%	3.8%
CBA	7.0%	0.0%	6.7%	-6.7%
WBC	0.0%	7.0%	4.0%	3.0%
CSL	7.0%	4.0%	5.5%	-1.5%
NAB	5.0%	7.0%	3.7%	3.3%

Source: Wilsons.

Westpac (WBC) – cyclical recovery with new cost cut program

We think the worst is behind Westpac from a regulatory perspective – a key reason we have historically flagged to avoid WBC. The reduction in potential risks, the prospect of a housing-led (Westpac's core strength) recovery suggest WBC can outperform. WBC offers value versus its peers on both a price to book (PB) and price to earnings ratio (PE) relative to its historical valuation levels.

The recent 1Q21 trading update saw credit provisions roll back (1 of 2 banks to wind back provisions), while capital levels were well ahead of market expectations. This sets WBC up for capital management at FY21 results in November, and makes a buy-back of ~$2bn (or ~50 cash per share) possible.

Near-term, WBC is due to announce a new 3-year cost reduction plan in May. We believe this is part of a multi-year turnaround for WBC to lift ROE from <4% in FY20A to potentially early double digits in FY23/24, which is more aggressive than the market's view.

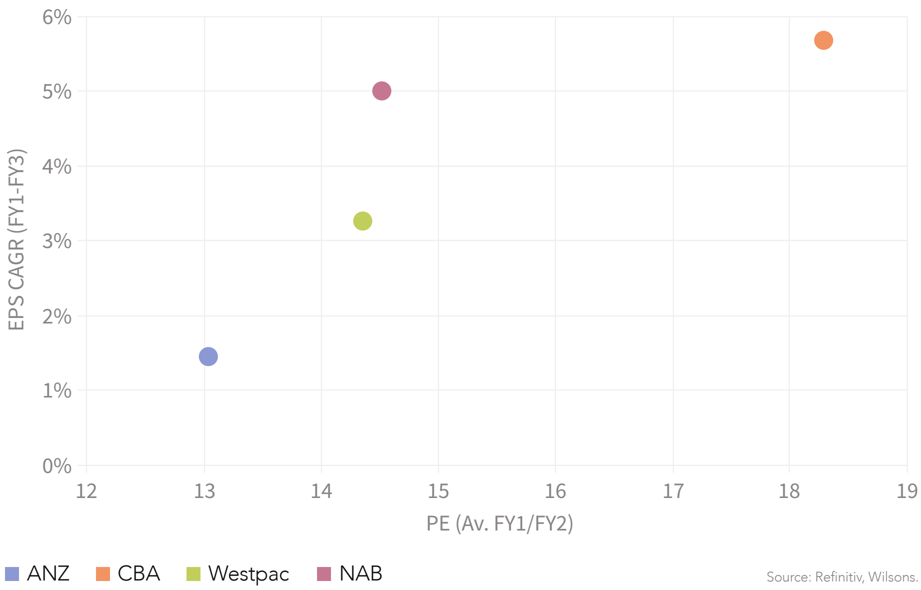
- Focus List Weight: **7%**.

Commonwealth Bank (CBA) – premium multiple challenges further outperformance

CBA's traditional premium versus peers has expanded dramatically over 2020. Strong execution, capital, earnings growth and progression through the minefield of regulatory issues has seen CBA's PB reach almost 2.0x. The PB gap to peers also expanded significantly, which in the case of Westpac (WBC) reached its widest level in a decade earlier this year.

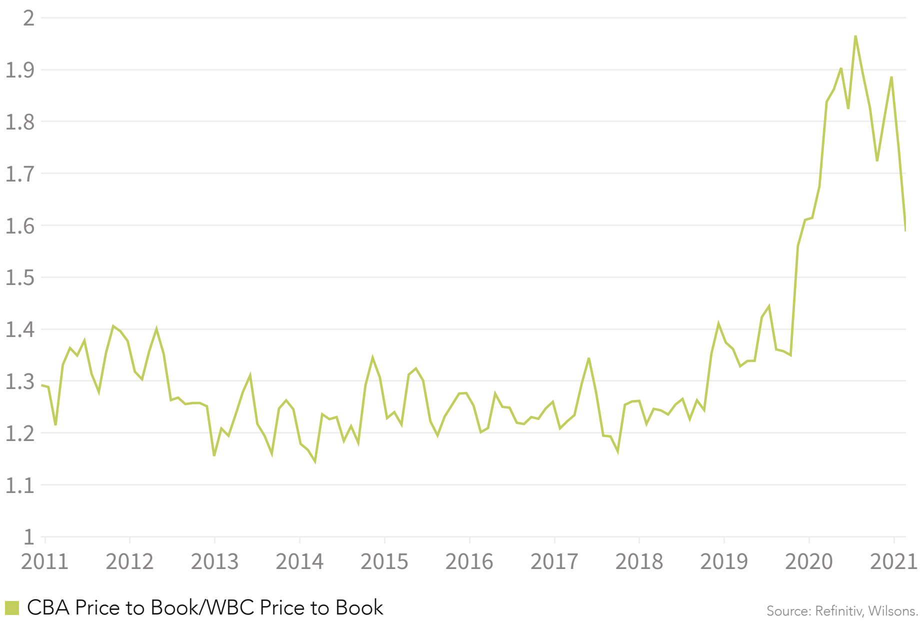
We think this makes relative outperformance from here more difficult. We like the earnings outlook and the capital position of CBA – but this comes at a hefty premium to peers. In an improving cycle – to be led by housing – the cheaper banks are likely to outperform in our view. We have switched from CBA to WBC.

Exhibit 2: WBC perspective growth is mid-pack – cost out program could help lift EPS forecasts



Source: Refinitiv, Wilsons.

Exhibit 3: CBA's PB multiple relative to WBC has expanded dramatically



Source: Refinitiv, Wilsons.

National Australia Bank (NAB) – well-positioned to the improving cycle

We have increased our weighting by 2% points in NAB, putting the Focus List at 1x overweight the banks. NAB offers exposure to the improving cycle, with the potential for capital returns as early as FY21 results in November.

Provisions were held flat in 1Q21, suggesting the peak of the provision cycle is behind us. NAB's management team is well-experienced, which offers the potential to finally lift NAB's ROE to be more in line with peers after decades of underperformance. Buy the economic and ROE recovery.

- Focus List Weight: **7%**.

Worley (WOR) – higher conviction in the recovery

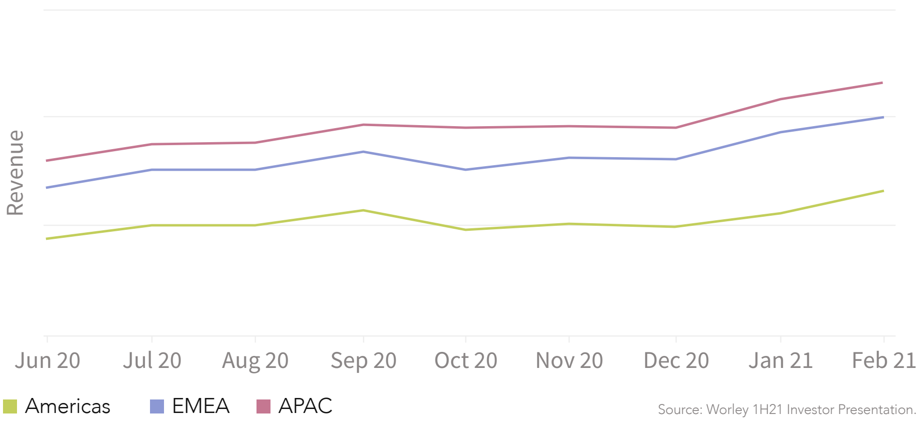
WOR's 1H21 result provided surprise to the upside on both the dividend and outlook. With downgraded results pre-announced in December, this result provided insight into:

- The cost savings target increased to $350m by June 2022, previously $275m by Dec 2021
- The acceleration in sustainability projects, which have a more favourable gross margin % in comparison to WOR's historical services
- Since the end of December, the sales pipeline has improved markedly to be at a 12-month high, with the vaccine rollout and economic recovery increasing the demand for WOR's services (particularly as COVID-19 site restrictions fall)

The improved outlook has meant we now have more conviction on WOR's recovery story. WOR provides strong leverage to the improving opex and capex cycle across hydrocarbons which is now starting to lift. Over the medium-term, the transition into renewables now looks increasingly likely, and this provides further growth opportunities for WOR over the next 3-5 years. Success on both fronts could see earnings doubling over the FY22-F24 period. We think WOR will outperform the market over the next 12-18 months.

Focus List Weight: **4%** (versus 3% previously).

Exhibit 4: WOR's earnings downgrade in December looks to have occurred at the bottom of the cycle



Source: Worley 1H21 Investor Presentation.

CSL Limited (CSL) – heightened risk of underperformance

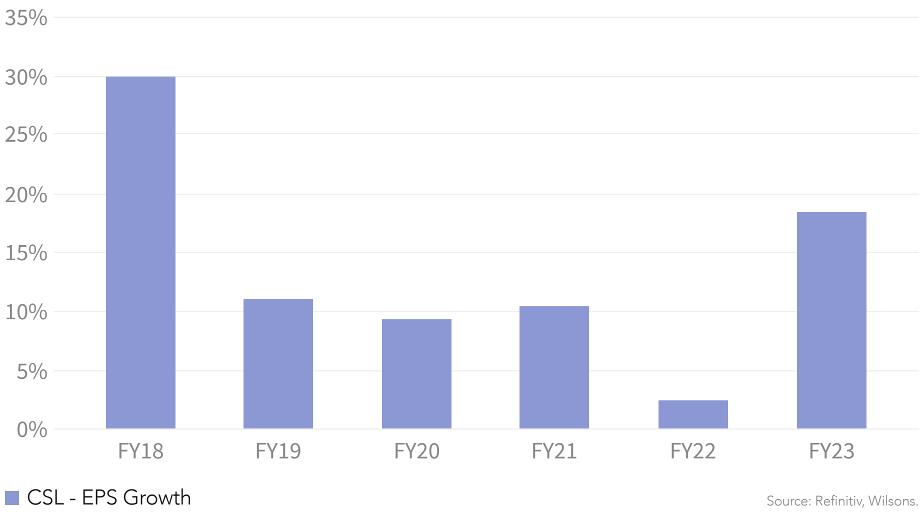
Although we like CSL's longer-term story and recognise a strong 1H21 result, we believe the company will struggle to generate earnings growth over the next 18 months compared to the FY17-FY20 period.

Plasma collection fell ~25% in CY20 with the persistence of COVID-19 infection rates globally, with collection challenges likely to impact immunoglobulin (IG) blood product availability in 2021. As critical products to CSL's earnings post-COVID-19, stalled volume growth would negatively impact CSL, particularly with a PE valuation at ~40x, well above market and peers.

We think the cyclical rotation will weigh on the share price over the next 12 months, and until there is greater confidence around plasma collection, CSL is unlikely to outperform the market.

Focus List Weight: **4%** (versus 7%).

Exhibit 5: Slowdown in CSL's EPS growth for FY22E



Source: Refinitiv, Wilsons.

Focus List Table

Ticker	Name	Sector	Focus List Weight	Classification	EPS CAGR (FY1-FY3)	PE (12mth FWD)	Div Yield (12mth FWD)	ROE (12mth FWD)
AVN	Aventus	Real Estate	4.0%	Asset Valuation Plays	4%	14.2	6.4%	8%
NWS	News Corporation	Communication Services	2.0%	Asset Valuation Plays	25%	40.8	0.7%	4%
ALL	Aristocrat Leisure	Consumer Discretionary	3.5%	Cyclical Quality Growth	26%	26.3	1.6%	22%
WOR	Worley	Energy	4.0%	Cyclical Quality Growth	35%	18.3	3.7%	4%
BHP	BHP Group	Materials	10.0%	Cyclical Quality Growth	-8%	14.2	4.3%	26%
JHX	James Hardie Industries	Materials	3.0%	Cyclical Quality Growth	15%	25.7	1.7%	33%
MQG	Macquarie Group	Financials	6.0%	Cyclical Quality Growth	7%	18.3	3.7%	14%
ANZ	ANZ	Financials	7.0%	Cyclical Value	1%	13.0	5.1%	10%
OZL	OZ Minerals Limited	Materials	3.0%	Cyclical Value	6%	21.2	1.1%	10%
NAB	NAB	Financials	7.0%	Cyclical Value	5%	17.1	4.8%	9%
RWC	Reliance	Industrials	3.0%	Cyclical Value	4%	20.2	2.5%	12%
STO	Santos Limited	Energy	4.0%	Cyclical Value	3%	17.1	1.3%	9%
SUL	Super Retail	Consumer Discretionary	3.0%	Cyclical Value	-16%	11.8	5.3%	19%
SVW	Seven Group Holdings	Industrials	4.0%	Cyclical Value	10%	14.6	2.2%	16%
WBC	Westpac	Financials	7.0%	Cyclical Value	3.3%	14.4	4.8%	9%
AZJ	Aurizon Holdings	Industrials	3.0%	Defensive Growth	6%	14.0	7.2%	13%
NST	Northern Star Resources	Materials	3.0%	Defensive Growth	21%	13.2	2.0%	19%
TCL	Transurban Group	Industrials	4.0%	Defensive Growth	18%	728.9	3.8%	4%
APX	Appen	Information Technology	3.0%	Secular Growth	31%	36.2	0.7%	15%
CSL	CSL	Health Care	4.0%	Secular Growth	10%	41.1	0.8%	28%
GMG	Goodman Group	Real Estate	3.0%	Secular Growth	11%	24.7	1.8%	11%
RMD	ResMed	Health Care	2.0%	Secular Growth	10%	36.8	0.7%	25%
TLX	Telix Pharmaceuticals	Health Care	2.0%	Secular Growth	-	-	0.0%	-27%
XRO	Xero Limited	Information Technology	3.5%	Secular Growth	54%	23084.9	0.0%	15%
EML	EML Payments	Information Technology	2.0%	Secular Growth	42%	40.8	0.0%	9%

Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

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

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