# Follow the Earnings Momentum

Our weekly view on Australian equities.

11 November 2021

# Rollover in Earnings Momentum Continues

The Wilsons Australian Equity Focus List has been updated following a number of earnings announcements and company updates in the past month. A rollover in earnings momentum we flagged in September has continued for the S&P/ASX 200.

Read Increasing Cross Currents - How are we Positioned?

Some of this is a function of falling iron ore prices and domestic lockdowns, but several stock-specific situations have seen earnings slip from FY22E and into FY23E. We see the key implication for investors being the need to be more selective around portfolio positioning.

The focus on earnings momentum could become even more important over FY22E as the impact of low COVID-19 base effect fades and the recovery becomes more nuanced – the prospects of an uneven recovery between companies will likely intensify.

Our changes to the Focus List are significantly influenced by where we see earnings momentum heading into FY22E. We moved banks to an underweight position, as cost pressures are likely to crimp earnings growth across the sector.

ResMed (RMD) has been removed following a disproportionate increase in the share price vs the potential sales improvement from a competitor product recall.

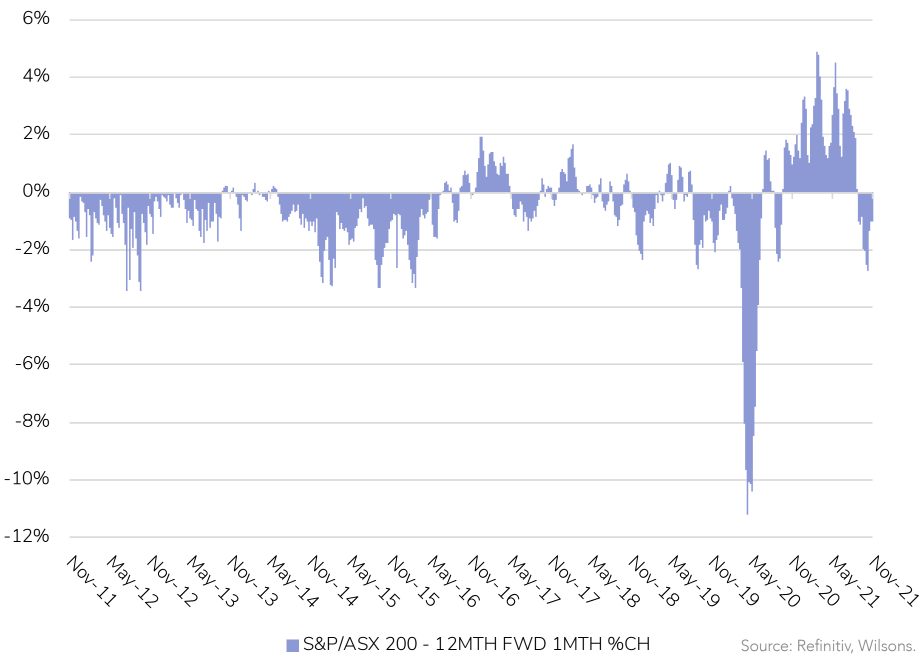
We have added banking disruptor Judo Capital (JDO) following the recent IPO. Weightings have been increased in Aristocrat Leisure (ALL), Goodman Group (GMG) and Macquarie Group (MQG), where we see the prospects of positive earnings momentum remaining in place through 2022.

**Exhibit 1: Changes to the Focus List**

| Company | Ticker | Old Weighting | New Weighting | Change |
|---|---|---|---|---|
| **Consumer Discretionary** | | | | |
| Aristocrat Leisure | ALL | 3.5% | 4.5% | 1.0% |
| **Financials** | | | | |
| Westpac Banking Corp | WBC | 9.0% | 4.0% | -5.0% |
| Macquarie Group | MQG | 3.0% | 5.0% | 2.0% |
| Judo | JDO | 0.0% | 3.0% | 3.0% |
| **Healthcare** | | | | |
| ResMed | RMD | 2.0% | 0.0% | -2.0% |
| **Real Estate** | | | | |
| Goodman Group | GMG | 3.0% | 4.0% | 1.0% |

Source: Refinitiv, Wilsons.

**Exhibit 2: Earnings upgrade momentum has rolled over for the first time since the beginning of the pandemic**




Source: Refinitiv, Wilsons.

### Banks to underweight

We downgrade our banks' exposure from market weight to underweight following the bank reporting season. Two themes dominated the outlook for banks in this post-COVID era:

1. Despite buoyant credit industry credit growth competition remains intense, capping revenue growth.
2. Costs are proving sticky, with substantial inroads into sustainable cost reductions proving challenging to achieve. This is from increased investment in risk functions, technology, and core retail banking, as both ANZ and Westpac highlighted to meet the increased lending volumes.

The combined effect of these two trends is a drag on earnings growth. With banks' valuations largely normalised post-March 2020 sell-off, we are more sensitive to a slow down in earnings momentum.

For more on bank sector valuations read Bank Reporting Season: More Macro, Less Micro

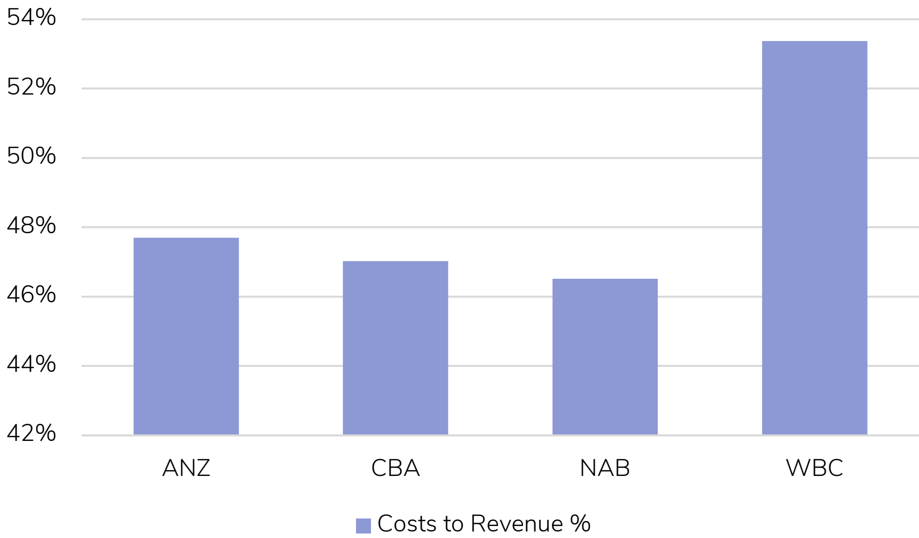
### Westpac (WBC) | reduced 9% to 4%

We had hoped to see the combination of revenue improvement, cost control and capital management at WBC FY21 results. Instead, we were left underwhelmed on revenue momentum, a material lift in costs - increasing the risk of WBC $8bn costs base target being missed - and capital management falling short of expectations. The improvement in the earnings trajectory we were looking for has been pushed out.

Until WBC can clear its regulatory issues, which are consuming costs and management time, WBC is playing the game with effectively one arm tied behind its back. Despite the valuation appeal (mid-teens discount to its sector relative price-to-earnings ratio (PER) (in line with ANZ), we think investors will need to see proof that earnings momentum can be restored before a potential rerating can be considered.

The contrast to NAB is stark, where execution and earnings momentum has now been in place to two results. Whilst early in the innings, and we are well aware of NAB's poor track record of execution over the past two decades, so far, the reset program within NAB under fresh leadership is showing good momentum. Our preference order within the banks is NAB 7%, WBC 4% and ANZ 3%. We are 0.75x underweight the major banks.

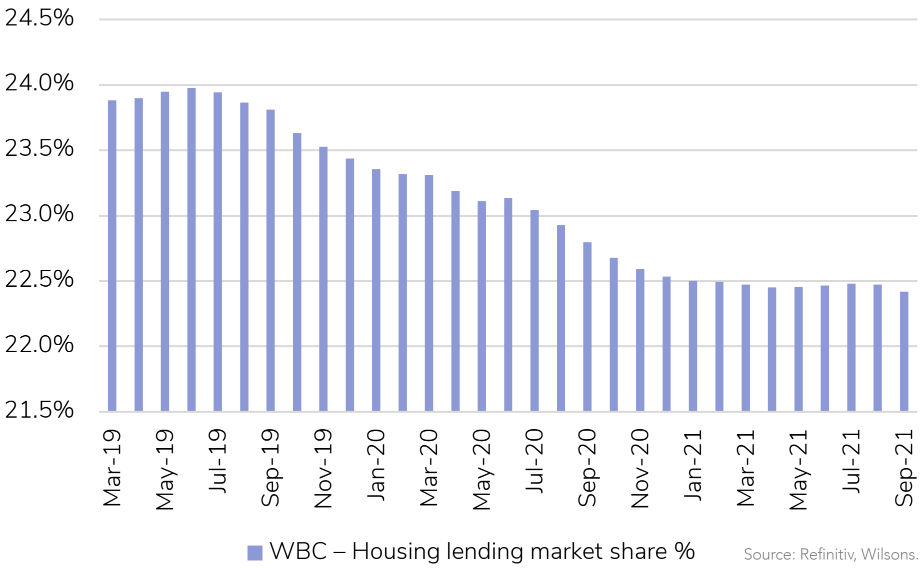
**Exhibit 3: WBC cost base remains too high relative to peers growing +7%* in FY21**




* Core cost base ex 'Fix Spending", Specialist Businesses, Notable Items.

Source: Refinitiv, Wilsons.

**Exhibit 4: WBC continues to lose market share in housing, an area of traditional strength**




Source: Refinitiv, Wilsons.

### Judo (JDO) | added 3%

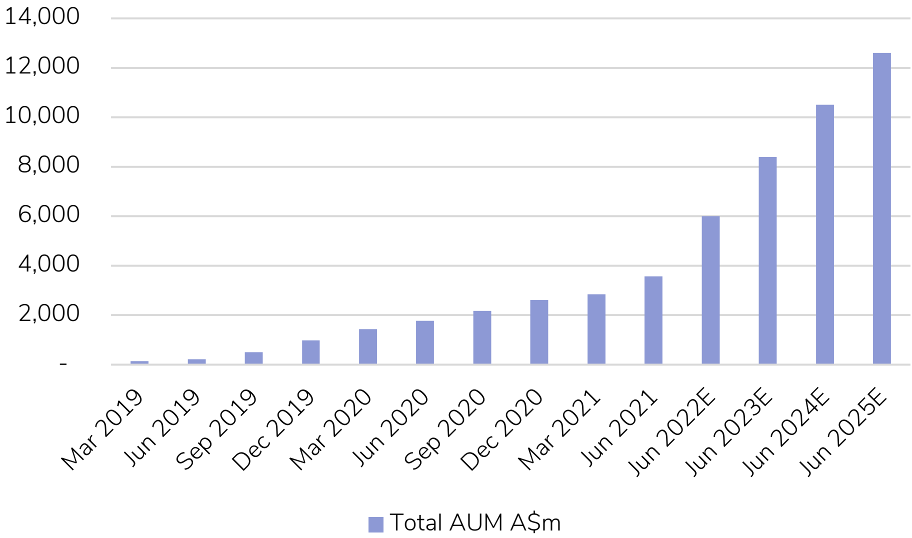
JDO is a bank disruptor focused exclusively on business lending – the most profitable area of core banking. We see a period of rapid growth ahead for JDO, driven by low penetration in business lending and a service-based business proposition creating a point of difference with customers. JDO is expected to generate cash earnings in FY22E (5 years after inception) and should generate low-mid-teens return on equity when scale is reached.

The big four Australian banks have business lending loan books totalling $650bn. The JDO loan book is just $4bn and is expected to grow to $6bn by June 2022. This implies a <1% market share. We see a multi-year pathway for JDO to grow its presence in business lending by being selective in which parts of the market it plays in. The business grew 100% in FY21, and JDO PDS is looking for ~70% book growth in FY22E. This compares to low single-digit across the major banks driven primarily by system growth.

The cycle remains a tailwind, with bad debts expected to remain low over the next 2-3 years. While business lending carries more risk than residential lending, +70% of JDO loans are secured by property, with the remaining 30% secured by other assets. JDO does not lend unsecured.

From a value perspective, JDO will be valued on the size of the lending book and the speed at which JDO can grow. We believe the business does not require equity capital this side to $10bn of loans. If we assume the current price to book multiple holds, we can see a valuation of in the early $3.00 by the end of 2024, which implies at ~11% CAGR in the share price. We do not see JDO paying dividends over the next three years.

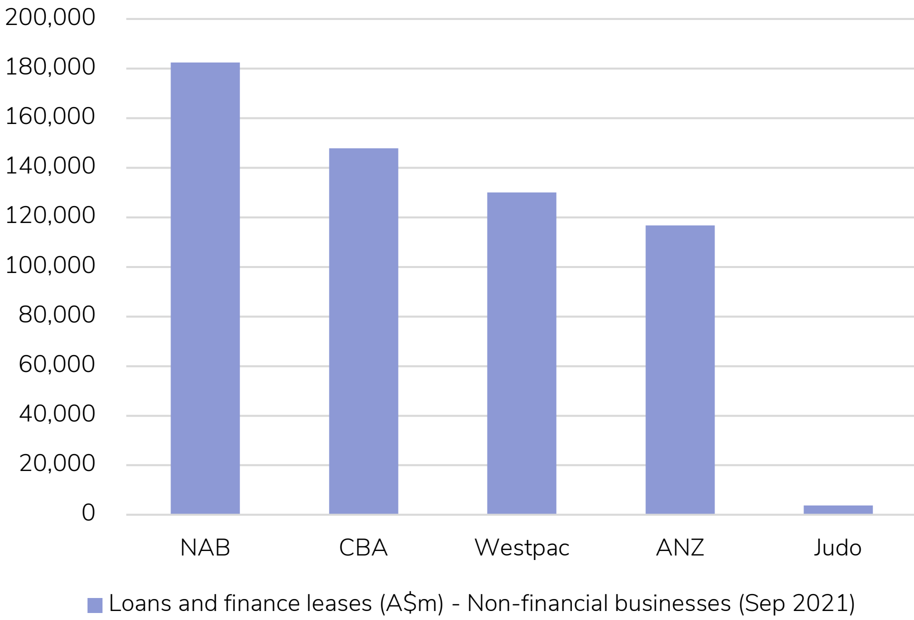
**Exhibit 5: Loan book growth**




* JDO forecasts FY22E. Wilsons estimates FY23E-25E.

Source: Refinitiv, Wilsons.

**Exhibit 6: JDO has <1% market share of loans of the big four banks**




Source: Refinitiv, Wilsons.

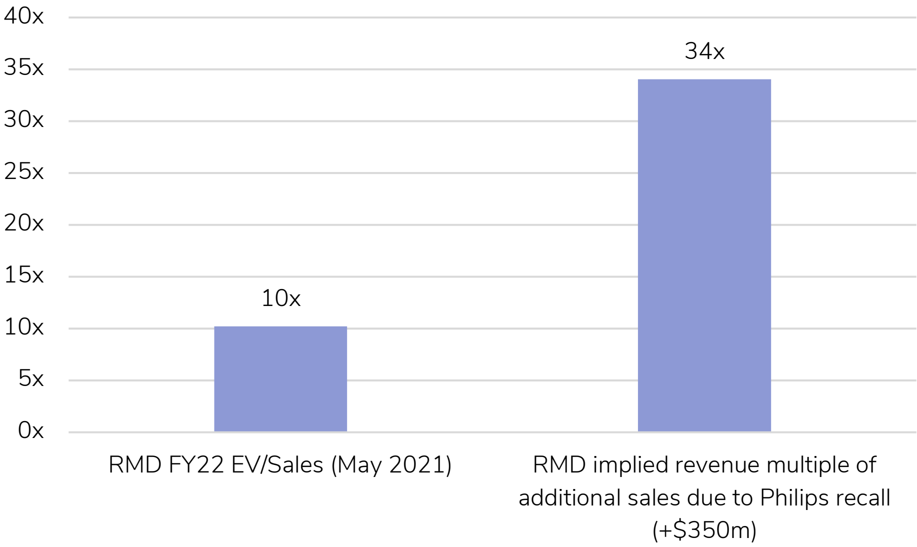
**Healthcare | removing ResMed (RMD)**

Investors had added over 30% to RMD's market capitalisation since mid-May 2021 when news broke that Phillips - RMD's no.1 global competitor - had voluntarily recalled its CPAP machines on safety grounds. With a competitor effectively out of the market for an estimated 12-18 months, RMD can use this period to pick up market share. RMD estimates this benefit at $US300-350m in sales.

Our issue is the share price now is baking a permanent lift in market share of at least $US300m. While we have no doubt RMD will retain some of this market share, Phillips remains confident that the issue can be largely solved by mid-2022.

If we pull apart the incremental gain in market cap and RMD's guide on sales improvement, the market is valuing Phillips recall-related sales at 30x revenue. This compares to RMD's valuation in May 2021 of 10x revenue (has been pretty steady for a number of years). Yes, incremental sales of this order will likely be margin accretive, but we worry that the market is simply over capitalising gains that may not be durable.

**Exhibit 7: RMD revenue uplift from Phillips recall is being valued at x3 RMD's core business**




Source: Refinitiv, Wilsons.

Heading into 2Q and 3Q, RMD has flagged higher costs and potential for supply chain issues with chip shortages. We think the setup for further outperformance is now more challenging.

# Weighting Changes

### Macquarie Group (MQG) | 3% to 5%

- Strong execution, conducive market backdrop across asset management and capital markets, and the possibility that MQG scales its competitive advantage in clean energy all imply a larger weighting than 3%. The earnings environment continues to look favourable for MQG.
- In our view, MQG remains to play on four thematics: 1) technology; 2) infrastructure; 3) energy/clean energy; and 4) asset management.
- MQG's view of market opportunities is reinforced by two capital raises over the past 6 months – first a cut in the dividend payout ratio and second a ~$2bn raising in early November.
- Valuation has expanded to 22x PER, which given peer alternative asset managers like Apollo Global (APO.US), Blackstone (BX.US) and KKR (KKR.US) trade between 30-40x PER should not be seen as a barrier. Additionally, it is not out of the question that MQG can produce an ROE of 20% – something the market has given up on due to higher capital requirements over the past 5 years. In the half, ROE jumped from 14.3% to 17.8%.

### Goodman Group (GMG) | 3% to 4%

- Like MQG, GMG cut its dividend payout ratio to reinvest into growth initiatives. With a period of accelerated reinvestment ahead of GMG – given requirement for logistic clients to modernise supply chains and inventory management thanks to COVID-19 – we see an extended period where GMG delivers above-average earnings growth.
- Guidance for FY22 has been upgraded from 10% to 15%, which could look conservative depending on project timings.
- GMG alignment remains strong, with key management in August having LTI tested over a 4 year period (up from 3) and vesting period over 5-10 years (up from 3-5 years).

### Aristocrat Leisure (ALL) | 3.5% to 4.5%

- ALL continues to execute at a high level, with the team willing to make bold moves to position the company into areas of market growth.
- The $A5bn proposed purchase of UK gaming company Playtech is further evidence of this. ALL can generate high single-digit organic gaming growth, supplemented with large-scale acquisitions every 4-6 years, lifting earnings growth to 15-20%. Playtech puts ALL into the US digital gaming market with a current TAM +$US70bn and something which would have taken +5 years to replicate organically.
- ALL trades on Industrials ex financials multiple, with the prospects of 20% earnings-per-share cumulative average growth rate (EPS CAGR) into FY25E (2-3x higher than market).

## Exhibit 8: Focus list active weights

| Company | Ticker | Weighting | Market Weight | Active Weight |
|---|---|---|---|---|
| **Communication Services** | | | | |
| News Corp | NWS | 3.0% | 0.1% | 2.9% |
| Seek | SEK | 3.0% | 0.6% | 2.4% |
| Telstra Corporation | TLS | 4.5% | 2.1% | 2.4% |
| **Consumer Discretionary** | | | | |
| Aristocrat Leisure | ALL | 4.5% | 1.4% | 3.1% |
| Silk Laser Australia | SLA | 2.0% | 0.0% | 2.0% |
| **Energy** | | | | |
| Santos | STO | 5.0% | 0.7% | 4.3% |
| **Financials** | | | | |
| Insurance Australia Group | IAG | 5.0% | 0.5% | 4.5% |
| Judo | JDO | 3.0% | 0.1% | 2.9% |
| National Australia Bank | NAB | 7.0% | 4.3% | 2.7% |
| Macquarie Group | MQG | 5.0% | 3.4% | 1.6% |
| Westpac Banking Corp | WBC | 4.0% | 3.8% | 0.2% |
| Australia and New Zealand Banking Group | ANZ | 3.0% | 3.6% | -0.6% |
| **Healthcare** | | | | |
| Telix Pharmaceuticals | TLX | 2.0% | 0.1% | 1.9% |
| CSL | CSL | 8.0% | 6.5% | 1.5% |
| **Industrials** | | | | |
| Seven Group Holdings | SVW | 4.0% | 0.4% | 3.6% |
| Qantas Airways | QAN | 4.0% | 0.5% | 3.5% |
| **Information Technology** | | | | |
| EML Payments | EML | 4.0% | 0.0% | 4.0% |
| Xero | XRO | 2.0% | 1.0% | 1.0% |
| Afterpay | APT | 2.0% | 1.6% | 0.4% |
| **Materials** | | | | |
| BHP Group | BHP | 8.0% | 4.9% | 3.1% |
| James Hardie Industries PLC | JHX | 4.0% | 1.1% | 2.9% |
| OZ Minerals | OZL | 3.0% | 0.4% | 2.6% |
| Northern Star Resources | NST | 3.0% | 0.5% | 2.5% |
| **Real Estate** | | | | |
| Healthco Healthcare and Wellness Reit | HCW | 3.0% | 0.0% | 3.0% |
| Goodman Group | GMG | 4.0% | 2.0% | 2.0% |

Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

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

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