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Three Oversold Structural Growers

Our weekly view on Australian equities.

16 March 2022

Issued by Wilsons Advisory and Stockbroking Limited (Wilsons) ABN 68 010 529 665 - Australian Financial Services Licence No 238375, a participant of ASX Group and should be read in conjunction with the disclosures and disclaimer in this report.

Why we Still Like ALL, JHX, SEK

We reiterate our positive stance on Aristocrat (ALL), James Hardie (JHX), and SEEK (SEK). All three companies have seen their share prices come under pressure this year, despite earnings upgrades from both JHX and SEK.

With growth stocks out of favour at present, we unpack the key stock issues investors are focused on. In our view, all three companies provide long-term structural growth qualities which are presently being discounted by the market. ALL, JHX, SEK combined account for 11.5% of the Wilsons Australian Equity Focus List.

Australian Growth vs Value

Over the past 6 months, Australian growth stocks have underperformed the market by ~4%. Relative to value stocks, the underperformance is closer to 8%.

Most of the underperformance occurred through January 2022, alongside a significant global repricing of interest rate risk in bond markets. The longer duration of cash flows inherent in growth stocks makes them more sensitive to a change in the discount rate or long-term bond yields.

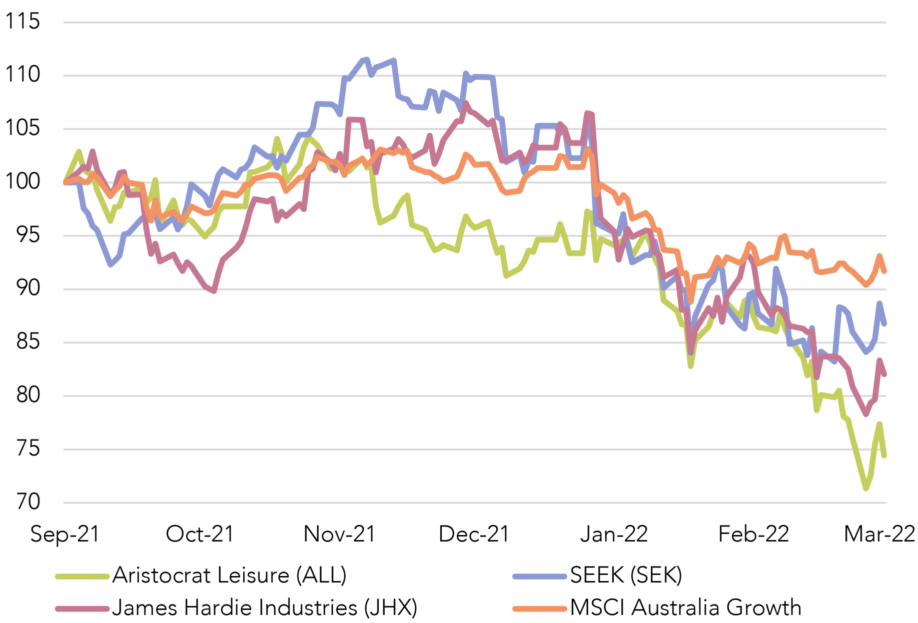
Through March, the relative performance of value over growth has diminished, partly as a function of global growth expectations, which are no longer increasing as they were for much of 2021.

With bond yields continuing their upward climb during March, the environment for growth stocks still presents a headwind in the short-term.

It may not be until mid-year when greater clarity emerges on both the pace and ultimate level of interest rates in the US is known, before the pressure on growth stocks potentially eases.

Our view remains that over the medium to long-term, if companies can grow their earnings above market, share prices will follow. In the case of ALL, JHX, and SEK, we still believe they can grow earnings well ahead of the market over the next 3 years.

Exhibit 1: ALL, JHX and SEK have all been hit harder than MSCI Australia growth index



Source: Refinitiv, Wilsons.

Exhibit 2: Metrics compared ALL, JHX and SEK

Company Name	Ticker	Share Price	Price Change % YTD	Market Cap (A$b)	Forecast Multiples: 12mth fwd PE (Today)	Forecast Multiples: 12mth fwd PE (31/12/2021)	EPS CAGR % (FY1-FY4)	EPS Revision (3 Mth % Change)
Consumer Discretionary								
Aristocrat Leisure	ALL	35.40	-19%	24.0	20.9	26.3	15%	-3.1%
Materials								
James Hardie Industries	JHX	44.49	-20%	20.1	18.4	25.8	22%	8.4%
Communication Services								
SEEK	SEK	28.53	-13%	10.2	38.5	50.1	28%	8.3%

Source: Refinitiv, Wilsons

Aristocrat (ALL)

Focus List 4.5% weight

Global Gaming with Lazy Balance Sheet

ALL has two viable paths to create long-term shareholder value;
1) Land-based gaming business remains the clear leader in AU and US; 2) Digital gaming – which takes ALL content and gaming skills into a high growth online gaming market. North America online is expected to see a 25% CAGR 2018-2025, lifting the market size to >US$100bn pa.

ALL continues to spend heavily on R&D, especially in digital gaming. We see this as prudent, given the large market, and evidence to date suggests ALL can create compelling content.

The ALL business generates a high level of free cash flow (FCF) and produces a return on equity of >20%. The business should be able to deliver early-mid teens 3-yr CAGR. The net cash balance sheet provides M&A and or capital management opportunities not currently being valued by the market.

Key Issue 1: Failed M&A

ALL walked away from the UK Playtech acquisition after failing to get shareholder support. This was viewed as a key asset to win the US digital gaming market and would provide a sleeve of additional earnings growth over the medium-term. Having raised $A900m equity for the acquisition, the balance sheet is now net cash to the tune of $1.3bn. The combination of M&A that has miss fired and a lazy balance sheet has weighed on the market. Key peer IGT has fallen by a similar amount over the past 6 months, reflective of broader sell-off in high growth names.

We do not rule out further M&A (there are a number of potential assets which ALL can acquire), while a return of capital remains a fallback option (unlikely in our view).

Key Issue 2: High growth = high multiple

ALL can grow earnings in early to mid-teens EPS, double its industrials peers over the cycle. We have never ascribed to the view that ALL trades on a high multiple. The multiple peaked at just under 30x, in line with the All industrials ex financials index.

Near-term growth could be closer to +25% as land-based gaming continues to rebound. While group EPS is expected to grow in the mid teens over the next few years. Currently trading on a PE multiple of 21x, ALL does not seem expensive relative to its earnings growth potential.

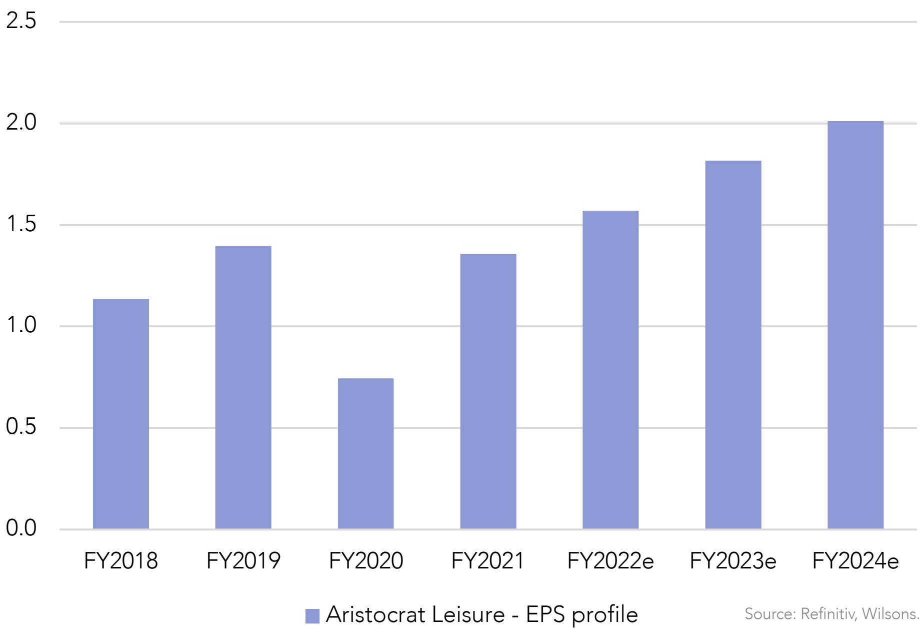
Key Issue 3: Russian exposure

ALL generates less than 3% of global revenue from Russia, representing <$15m of annual earnings. A content creation division, Pixel United, previously had ~1k employees in Ukraine. Over 2/3 of these employees have now been relocated.

We do not foresee a lasting impact of a loss of Russian earnings.

Catalyst: 1H22 Results 19 May 2022

Exhibit 3: ALL earnings growth profile slows from FY23E but could be bolstered by >$3.5bn of funding capacity into acquisition



Source: Refinitiv, Wilsons.

James Hardie (JHX)

Focus List 4% weight

Global Housing Cycle has Further to Run

JHX is the global leader in fibre cement building fixtures and continues to take share in the US away from traditional wooden fixtures. Growth in the US will be increasingly led by a value maximisation strategy over volume. There is longer-dated growth in both Europe and Asia that the company is pursuing. The company has a strong approach to managing its fixed assets and delivering a return on capital of >20% through the cycle.

We believe the JHX growth is less dependent on the housing cycle than many believe given; 1) proven ability to grow through the cycle; 2) emerging B2C proposition, and 3) EU assets are much earlier in their lifecycle.

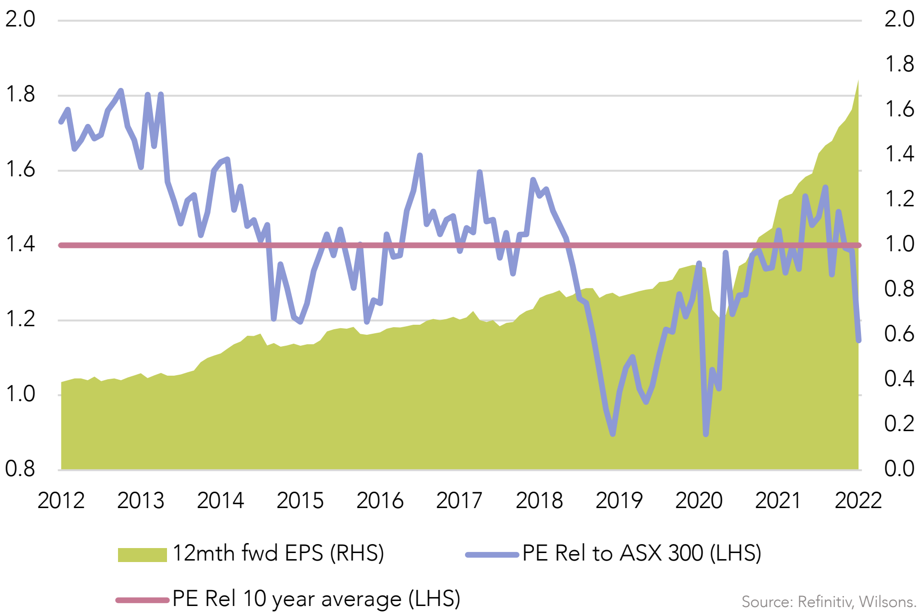
Key Issue 1: Surprise CEO departure (Jan 22)

The surprise dismissal of CEO Jack Truong in January 2022 (conduct issues) has raised a level of uncertainty around the company and its strategy.
The market was comfortable with Troung's strategy, and the push to B2C was still in its early stages.

While the company has the depth of talent across the organisation, we would not be surprised if an external appointment is made given the global reach of the business and push into consumer markets. In the short-term the interim CEO's key priorities are likely to remain on capacity expansion.

JHX is currently trading 10% below the All industrials, a steep discount to a 10-year average premium of 40%.

Exhibit 4: JHX PE relative has collapsed despite the above-market growth outlook



Source: Refinitiv, Wilsons.

Truong played an instrumental role in refining JHX's strategy; this strategy has now shifted towards the execution phase, placing greater importance on the broader management team/ workforce. We do not think a new CEO has to change JHX's core strategy. Since Truong's departure, JHX (-20%) has underperformed its key US rival Louisiana-Pacific Corp (LPX.US)(-12%), which has also had earnings upgrades. We think JHX's share price has overreacted to the loss of the CEO.

Key Issue 2: Slowing US housing cycle - interest rates and higher COGS

Despite providing two earnings upgrades this year (FY22 in Jan and FY23 in Feb), the market remains concerned around the duration of the cycle, particularly as the US rate cycle gets underway. New US home permits have looked to have peaked, whilst US homebuilders have flagged softness in new orders (primarily due to raw material shortages).

Rising mortgage rates at some point are likely to soften the demand outlook.

JHX (>55%) traditionally sees a greater proportion of its orders coming from repair and renovation (not new homes). With a greater focus on consumer and residential in this cycle, this should provide an offset if the cycle were too slow.

Initial guidance for FY23E was provided early in February, suggesting confidence in the peer result.

Catalyst: LPX results 02 May. JHX 1H22 Results 16 May 2022

SEEK (SEK)

Focus List 3% weight

Strong AU/NZ Employment Markets, Little Value ascribed to Offshore Growth Options

SEK's dominant market position in AU/NZ is currently enjoying the benefits of the cycle, with solid ad volumes and pricing power. SEK continues to push down the value-based pricing strategy with differential pricing for ads allowing strong forms of monetisation whilst dampening the impact of the cycle. Significant optionality in several parts of the business, if executed well, could imply a valuation of SEK >$40 per share.

Key Issue 1: High multiple – what is SEK's Growth Fund worth?

Despite the fall in the share price ($36 to $28), SEK's PER is the low 40x or an EV/EBITDA in the low 20s. Global ad platforms trade at ~20x. If we assume the core AU/NZ (~85% of group value) trades on 20x, then the remaining assets of SEK trade on an implied 23x (SEEK Growth Fund at stated book value $1.7bn 31/12/21). These assets include SEEK Asia, Brasil Online and 24.5% of Chinese employment portal Zhaopin.

There is an argument that Growth Fund needs to be written down to reflect the fall in public market multiples. However, a 20% reduction in the Growth Fund valuation would impact our SEK Group valuation by only 5%.

Key Issue 2: Normalisation of high volumes

Ad vols across AU/NZ are likely to reach a record in FY22E at ~3.0m ads, well ahead of the previous FY18 peak of 2.6m. We see ad volumes falling back to 2.7-2.8m in FY23-25E.

We think the market is still too focused on ad volumes, as distinct from revenue – which should hold up better than volumes as SEK continues on value-based pricing and removal of the recruiter fee discount. We believe the market is likely to underestimate the benefit from the switch to value-based pricing, much like it did with Carsales.com (CAR) and REA Group (REA).

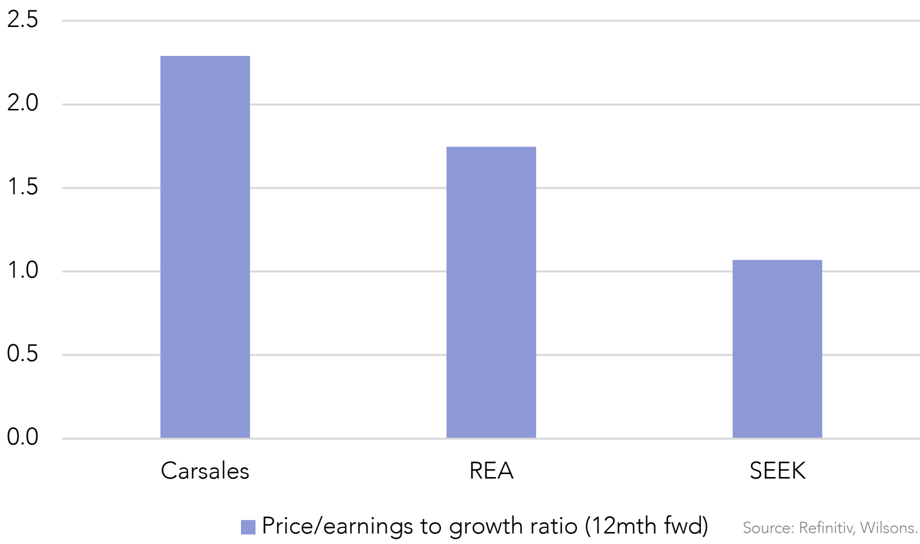
Key Issue 3: Can 2025 doubling of revenue from AU/NZ be met?

SEK's aspirational goal is to double revenue by 2025 in AU/NZ, implying an additional $1bn. What we can be certain about is that job ads will not double to ~6m by 2025, more likely ~$1.3bn by FY25E, primarily driven by the move to value-based pricing rather than ad vols.

For SEK aspirational $1bn target to be met, an incremental $700m of this revenue growth is expected to come from its own assets. The most likely source being assets in the SEK Growth Fund, which currently generates ~$70m of revenue, growing at >50% PCP. These assets cover online education, HR SaaS, contingent labour, which combined equal a global TAM of >$125bn. Consensus forecasts currently factor in only 30% of the aspirational upside $1bn.

Catalyst: FY22 Results 22 Aug 2022

Exhibit 5: SEK looks cheaper vs peers on a price/earnings over growth (PEG) basis



Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

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

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