Taking Stock – Key Themes to Watch From Reporting Season

Our weekly view on Australian equities.

08 March 2023

Softer Earnings with Pockets of Resilience

The February 2023 reporting season was a 'mixed bag', with a relatively large dispersion of outcomes between different sectors and companies.

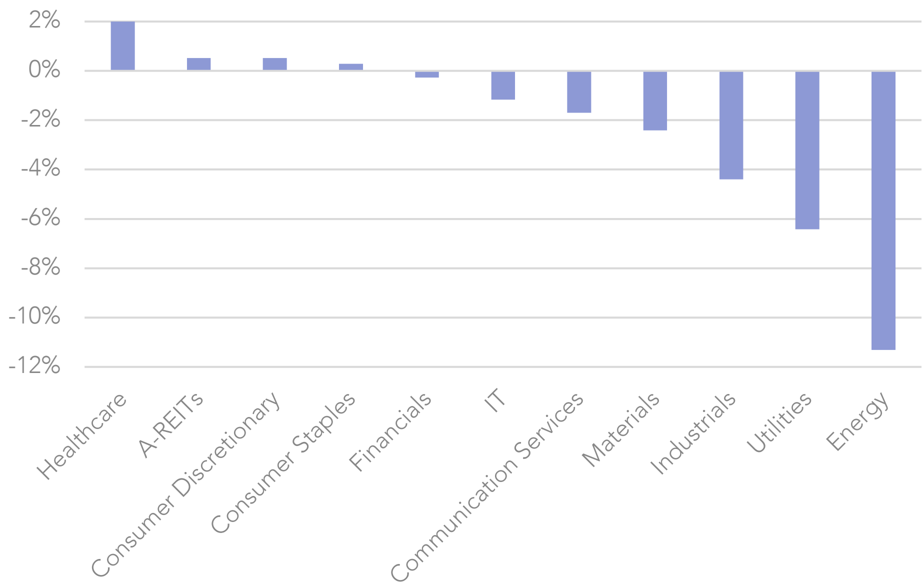
In aggregate, the ASX 200 experienced downgrades of ~2.3% to 12-month forward EPS expectations in February, as analysts factored further evidence of lingering cost pressures and a softening consumer into their forecasts.

Market expectations are now for the ASX 200 to grind out EPS growth of 5.0% and 0.7% in FY23 and FY24, respectively, representing a marked slowdown from the growth of 22.5% seen in FY22.

We think there is more downside for earnings in FY23 and FY24 as the economy is likely to soften further from here. However, we are seeing pockets of resilience that should hold up well through this downgrade cycle.

In this note, we explore how the Wilsons Australian Equity Focus Portfolio is positioned in relation to the key themes we are paying attention to from reporting season.

Figure 1: 12-month forward % EPS revisions in February 2023



Source: Refinitiv, Wilsons.

Key themes from reporting season:

1. Consumers are tightening their purse strings (on some things).
2. Cost pressures linger.
3. From lockdown to lift off – no sign of weakness in tourism and leisure.
4. Sunshine peeking through the clouds in the housing market.

Theme 1. Consumers Are Tightening Their Purse Strings (on Some Things)

Reporting season provided further evidence that consumers are paring back their expenditure on discretionary goods and big-ticket items, as pulled-forward demand from COVID unwinds and cost of living pressures eat into household budgets.

Bellwether retailer Harvey Norman's (HVN) trading update showed its Australian same-store sales fell ~10% in January compared to the year prior, while in the same period, JB HI-FI's (JBH) like-for-like sales growth decelerated to 1.5% (vs FY20) from 26% (vs FY20) a year earlier.

Figure 2: Through the year spending to 31 December 2022 – expenditure on services and essentials is significantly outpacing discretionary goods

Source: ABS Monthly Household Spending Indicator, Wilsons.

Figure 3: Inventory days are starting to rise for some consumer discretionary names

Name	Ticker	Inventories		Inventory Days	
		31-Dec-21	31-Dec-22	31-Dec-21	31-Dec-22
City Chic Collective	CCX	126	144	221	222
Bapcor	BAP	447	562	183	192
Harvey Norman Holdings	HVN	560	598	103	108
Eagers Automotive	APE	874	1,059	47	56
JB Hi-Fi	JBH	1,065	1,211	51	54

Source: Company filings, Wilsons.

Portfolio implications: Stay underweight consumer goods and retail, preference is to services

- The Focus Portfolio has no exposure to the Retail or Consumer Goods sectors which we think are close to peak (cyclical) earnings.
- Our preference is towards companies in the Consumer Services sector that are continuing to benefit from the shift of spending from goods to services and have attractive long-term earnings growth potential. We are ~5% overweight consumer services with a portfolio weight of ~8% vs the benchmark weight of ~3%.
  - Our top pick in this sector is The Lottery Corporation (TLC) (Focus Portfolio 3%), which has predictable, infrastructure-like cash flows that are underpinned by its long-dated licences and the defensive nature of lottery demand which has historically been resilient through the cycle.

The moderating consumer demand backdrop has driven a rise in inventory levels for some names. Not only is sitting on elevated inventories often a forward indicator of softening demand, it can also create additional costs (e.g. warehousing) while it weighs on free cash flows and increases the risk of product obsolescence, which can necessitate an increase in promotional activity to clear stock.

A number of businesses, including JBH, have signalled that discounting is 'starting to build', which has contributed to our cautious stance towards retail and consumer goods, as weaker top-line growth combined with increased discounting and fixed cost deleverage is ultimately a recipe for weaker operating margins.

There has also been increasing commentary that consumers are 'trading down', with Woolworths (WOW) CEO Brad Banducci saying consumers were eating more at home rather than dining out, for example.

That said, it hasn't been all bad for consumer businesses.

Some consumer services companies produced strong results on the back of normalising spending patterns post-COVID with progressively more money being spent on services than goods. The Lottery Corporation (TLC) (Focus Portfolio 3%) had a stellar 1H23 result, which included EBITDA growth of +15.8% as lottery sales were resilient. At the same time, margins benefitted from an increasing penetration of the digital channel.

There were also pockets of resilience from retailers with well-capitalised core customers (i.e. with less mortgage debt) and store roll-out initiatives. In this vein, Universal Group (UNI) (Wilsons O/W) and Lovisa (Wilsons O/W) both released positive trading updates highlighting sales growth of +16.8% and 24.3%, respectively, in the first 7 weeks of CY23.

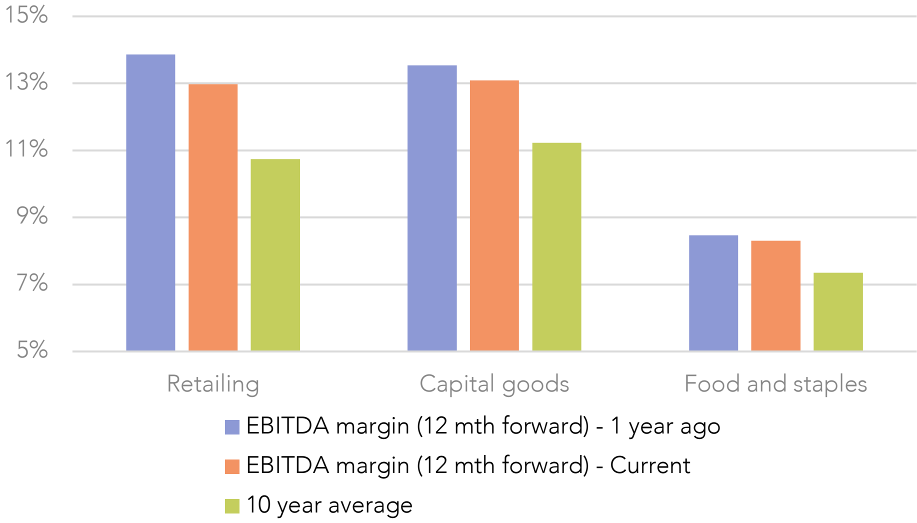
Theme 2. Cost Pressures Linger

Cost pressures have been broad-based to date, impacting everything from cradle (Baby Bunting's (BBN) infant goods stores) to grave (Invocare's (IVC) funeral services).

The most widespread (and potentially persistent) hit to margins has been from higher employee costs stemming from the tight labour market. For instance, **Cleanaway (CWY) (Focus Portfolio 3%)** reported a heightened number of job vacancies caused employee costs to rise +16% due to the need to pay more overtime and use more expensive labour hire contractors.

However, there is growing evidence that supply bottlenecks and energy costs are starting to ease, providing some relief to margins. Wesfarmers (WES) pointed to a 'normalisation' of its supply chains, while Super Retail Group (SUL) (Wilsons M/W), highlighted shipping rates improved markedly in 1H23.

Figure 4: Margins in key industrial sectors remain elevated above their long-run averages



Based on ASX 200 GICS classifications. Source: Refinitiv, Wilsons.

While we expect inflation to ease over the medium-term, the near-term threat to profitability is nevertheless meaningful and we see further downside to margins from here, particularly in more cyclical sectors with less pricing power (e.g. retail, discretionary goods).

Portfolio implications: Pricing power is king

We believe the best defence against cost inflation is pricing power.

High quality companies with resilient customer demand through the cycle and dominant market positions operating in attractive industry structures are best placed to protect their margins by raising prices.

The Focus Portfolio holds a range of businesses that fit the bill.

Figure 5: Examples of Focus Portfolio holdings with significant pricing power

Name	Ticker	Focus Portfolio %	EBITDA Margin FY22A	EBITDA Margin FY23E	EBITDA Margin FY24E	ISG comment
CSL	CSL	8.5%	32.9%	32.3%	35.5%	The dominant and lowest cost player in the global blood plasma industry. The market for Immonoglobulin (IG) products is supply constrained while underlying demand is highly defensive given IG is used to treat patients with a range of serious immunologic and neurologic diseases.
ResMed	RMD	3.5%	32.5%	32.9%	34.2%	#1 player in the global sleep apnea device market with an estimated ~70% share of theoretical demand in FY23E and plans to supply the whole market given its largest competitor is sidelined due to a product recall.
Telstra	TLS	3.0%	34.1%	34.0%	34.7%	The dominant Australian telco which is committed to raising prices annually (and cutting costs) to offset inflation. Mobile net ads were strong in in 1H23 in spite of higher prices, and the competitive setting is increasingly rational.
Insurance Australia Group	IAG	3.0%	9.2%	17.1%	15.6%	#1 general insurer in Australia, which has been rising premium rates strongly to offset rising perils costs (albeit there is a timing lag to margins). Even with higher premiums, customer retention rates remain high.
The Lottery Corporation	TLC	3.0%	21.2%	20.8%	21.0%	Monopoly player in the Australian lottery market (ex WA). Lottery sales have historically been highy resilient in economic downturns, and TLC has a proven ability to incrementally raise ticket prices over time.

Source: Refinitiv, Wilsons.

Theme 3. From Lockdown To Lift Off – No Sign of Weakness in Tourism and Leisure

While a number of services businesses performed admirably in 1H23, none have quite measured up to the strength of those leveraged to the rebound in travel, which reported exceptional results as the significant pent-up demand following years of restrictions continued to be unleashed by consumers.

We have been positive on the 're-opening thematic' for some time on the view that the market has underestimated the significant amount of pent-up demand for travel, which has helped keep air passenger volumes elevated, even in the face of elevated prices and the broader consumer slowdown.

Read Focus Portfolio Thematic – Global Reopening

We think this trend still has further to run in 2H23 and FY24, with consumers continuing to prioritise their expenditure on travel over other items while international travel remains well below pre-pandemic levels. China's recent re-opening from lockdown provides another tailwind for the sector.

Figure 6: The earnings of travel stocks rebounded sharply in the December 2022 half

Name	Ticker	Wilsons View	Revenue ($Am)			U/L EBITDA ($Am)		EPS revisions (last 30 days)
			1H22	1H23	% chg	1H22	1H23	
Qantas Airways	QAN	Focus Portfolio 3%	3,000	9,900	230%	-1,988*	2,450*	5.5%
Flight Centre	FLT	Not held	316	1,000	217%	-184.1	95.1	-3.7%
Corporate Travel	CTD	Not held	158	291	84%	18.2	51.3	-4.8%
Hello World Travel	HLO	Not held	29	73	151%	-7.7	15.6	50.1%
Tourism Holdings	THL^	Not held. Wilsons O/W	175	261	49%	21.9	70.8	19.9%

*NZD. ^EBITDAR
Source: Company filings, Refinitiv, Wilsons.

Portfolio implications: The re-opening still has legs, stay overweight Qantas (QAN) and IDP Education (IEL)

- Qantas (QAN) (Focus Portfolio 3%): We still believe QAN is an attractive investment opportunity, given its discount to US peers, the ongoing strength in travel volumes, its leaner cost base post-pandemic, and the attractive industry structure with Virgin/ Qantas operating as an effective duopoly. The 1H23 result affirmed our positive view as QAN guided that travel demand is expected to remain strong into FY24, while group capacity continues to increase strongly and air fares are still elevated.

Read Qantas – Flying Below Global Peers

- IDP Education (IEL) (Focus Portfolio 2%): We recently added IEL to the Focus Portfolio, which provides leverage to China's re-opening, and the broader recovery in international student placements globally. Longer-term, IEL is exposed to significant secular tailwinds, including the rise of India's middle class, increased university participation rates and rising international student mobility. IEL's 1H23 update demonstrated the ongoing acceleration in student placement volumes which increased +53% vs the pcp.

Theme 4. Sunshine Peeking Through the Clouds in the Housing Market

Housing-exposed companies have been heavily impacted by softer global housing markets, including James Hardie (JHX) (Focus Portfolio 3%). Weaker US housing construction activity saw JHX downgrade its FY23 NPAT guidance for the third time by ~10% to a range of US$600m-US$620m, implying broadly flat growth over the year.

Despite the near-term cyclical challenges, the market's reaction to these results was relatively sanguine.

In our view this reflects the fact that housing exposed shares had already de-rated considerably, pricing in cyclical weakness well before any EPS downgrades came through. As housing exposed companies are seemingly near 'peak pain' and approaching the end of their downgrade cycles, investors appear increasingly focussed on the attractive longer-term structural outlook for these companies and the valuation discount currently on offer for patient capital.

Portfolio implications: Continue to hold JHX.

We continue to see merit in holding quality cyclicals like JHX to protect against a milder-than-expected cycle (and to position portfolios for a recovery).

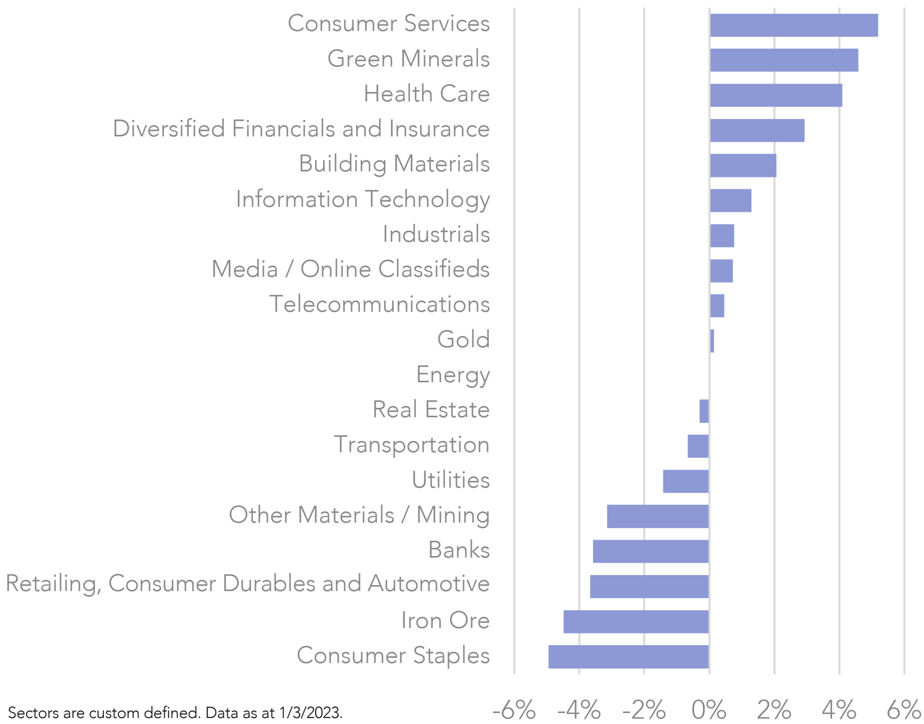
We agree with JHX's management which views this downturn as an opportunity to strengthen its competitive position by continuing to invest to take share from the smaller and less well-capitalised players.

JHX's long-term outlook remains positive given the structural undersupply of US housing since the GFC, and the large runway for growth in the fibre cement category globally.

Figure 7: Cyclical weakness was being priced into housing exposed stocks well before consensus EPS downgrades occurred

*US Housing materials is a simple average between JHX, RWC, REH.
Source: Refinitiv, Wilsons.

Figure 8: Focus Portfolio active positioning vs the ASX 200 by sector



Sectors are custom defined. Data as at 1/3/2023.
Source: Refinitiv, Wilsons.

Figure 9: Key Focus Portfolio results

Company Name	Ticker	Result Type	12 Mth Fwd EPS Revisions - last 30 days	Price Change % on day of result	ISG view
Stand out results					
Lottery Corporation	TLC	Half year	7.6%	4.7%	1H EBITDA +16% to $409.4m, beat expectations by +6% as margins benefited from growth in digital penetration (from 36.9% to 38.4%) and higher re-seller fees from Jumbo Interactive (JIN). TLC announced price increases planned for 2H23 which should be margin accretive.
Resmed	RMD	Half year	6.4%	2.1%	2Q23 results beat expectations, with diluted EPS of 1.37cps +12% vs Wilsons estimates. AS10/AS11 capacity fuelled further inventory build to fulfil excess demand over 2H23-25E driven by the Philips product recall which we expect to drive market share gains for RMD over the medium-term.
Qantas Airways	QAN	Half year	5.7%	-6.8%	1H U/L NPAT of $1.43bn hit the top end of guidance, although the market may have expected further upgrades. Net debt fell to $2.4bn - below QAN's $3.9 - 4.8bn target range - allowing the business to fund another $500m buyback representing 4% of QAN's market cap. Group capacity is now at 72% of pre-covid levels, with domestic capacity expected to exceed pre covid levels in 2H23 while international is expected to increase from 60% in 1H23 to 81% in 2H23.
CSL	CSL	Half year	5.4%	0.9%	1H23 NPATA beat Wilsons estimates by +8%, but did not invoke a FY23 guidance upgrade. Result was underpinned by strong immunoglobulin collection trends as expected.
Goodman Group	GMG	Half year	3.5%	2.1%	GMG provided an unsurprising upgrade to FY23 operating EPS growth, from 10% to 13.5%, though still below consensus at 15-16%. We expect further upgrades through the year.
Healthco Healthcare and Wellness REIT	HCW	Half year	2.6%	-1.0%	HCW's funds from operations (FFO) guidance for FY23 was upgraded from 6.8 cps to 7.1 cps. FY23 distribution was reaffirmed at 7.5 cents.
Macquarie Group	MQG	Quarterly	2.5%	0.7%	FY23 YTD NPAT was 'slightly up' vs FY22 YTD, whereas consensus forecasts (pre result) pointed to an NPAT decline of ~8% in FY23 vs pcp, implying MQG was tracking ahead of analyst expectations heading into 4Q23. Therefore, MQG saw upgrades post result.
In line results					
Netwealth Group	NWL	Half year	2.5%	2.7%	NPAT $30.6m (in line). FY23 net inflow guidance of $11bn reaffirmed. The trajectory of FUA this CYTD (+4.3%) was particularly positive, which bodes well for 2H23/FY24 earnings.
IDP Education	IEL	Half year	0.7%	-3.6%	1H23 EBITDA +49% to $144m was a +2% beat vs consensus, driven by strong student placements (volumes +53% vs pcp) while english language testing was softer than expected (volumes +5% vs pcp) partly reflecting the cycling of tough comps.
Pinnacle Investment Management Group	PNI	Half year	0.6%	-7.2%	1H NPAT was $30.5m, representing a ~16% miss vs Wilsons estimates. FY23 and FY24 NPAT estimates were downgraded as a result. However, the downgrades were driven by elevated costs due to growth investment ($6.5m) which should drive long-term returns for the business.
Telstra Group	TLS	Half year	0.5%	1.9%	1H EBITDA +11.4% vs pcp, which was a modest beat. FY23 guidance for EBITDA of $7.8-8.0bn, and medium-term targets (e.g. $500m cost out, high teens EPS CAGR), were reaffirmed.
Insurance Australia Group	IAG	Half year	-6.7%	4.5%	No major surprises with key figures were pre-released, although the full result provided additional colour on the drivers of IAG's medium-term margin recovery. Gross Written Premium guidance for FY23 upgraded from high single digit to ~10%, F23 margin guidance downgraded from 14-16% to 10%. Medium term margin goal of 15-17% was retained.
Telix Pharmaceuticals	TLX	Full year	-21.7%	6.2%	Telix reported $156M in global ILLUCCIX sales for FY22 with full market access only having been in place for the last semester. Telix reported an FY22 loss of $104M which was higher than our forecast (WILSe: $78M) due to lower other income and higher tax expense. Telix closed FY22 with $116M cash and negligible debt. Telix provided no guidance for FY23.

Name	Ticker	Result Type	12 Mth Fwd EPS Revisions - last 30 days	Price Change % on day of result	ISG view
Dissappointing results					
Cleanaway Waste Management	CWY	Half year	-4.6%	0.0%	1H EBITDA +18% vs pcp to $322.2m was in line with consensus and FY23 guidance was reaffirmed at $670m. EPS was below expectations due to higher finance costs and a higher number of shares on issue post the Aug 22 equity raise (which has only been partially deployed into the GRL acqusition).
Nine Entertainment Co Holdings	NEC	Half year	-5.8%	-2.9%	1H Revenue +5% to $1.4bn and EBITDA -9% to $370.5m were both broadly in line with expectations. The top line was reslient although margins were impacted by increased investment into its portfolio of original, licenced and sport content. Overall, a solid result amidst a challanging macro backdrop, with solid market share gains evident in key segments. No explicit guidance given for FY23 as the near-term outlook for ad markets remains uncertain.
James Hardie Industries	JHX	Quarterly	-9.6%	-4.3%	3Q23 update disappointed, missing consensus for the quarter while downgrading FY23 NPAT guidance another ~10% at the mid-point to a range of US$600m-US$620m
Resources					
Mineral Resources	MIN	Half year	0.7%	-0.1%	1H EBITDA of US$939m was below consensus of US$1,002m driven by timing issues on the Wodgina production ramp up and delays to the MARBL JV with Albermale. FY23 cost and production guidance was reaffirmed. Investor focus will be on the restructure of the MARBL JV which gives MIN a 50% stake in Wodgina lithium (up from 40%), and the new JV with Albermale will which give MIN a 50% stake in two lithium conversion assets in China at a cost of US$660m.
Northern Star Resources	NST	Half year	-0.5%	-1.5%	Uneventful update as expected. FY23 production and cost guidance was maintained. $300m buyback around 42% complete. 1H DPS of 11 cents, slightly above consensus of 10 cents.
BHP Group	BHP	Half year	-2.6%	-0.3%	U/L EBITDA of US$13.2bn was below consensus of US$13.9bn, although the dividend of 90 cps was a slight beat to consensus expectations of 88 cps and was supported by management's confidence in China's recovery. No changes to production or cost guidance (pre-reported) for the key WA iron ore and Escondida copper segments.
Allkem	AKE	Half year	-3.0%	3.7%	1H EBITDA of US$401m was a slight miss vs consensus driven by higher operating costs. Production guidance (pre-released) was unchanged after a downgrade of Mt Cattlin prior to the result. Balance sheet remins strong with net cash of US$552m.
Santos	STO	Full year	-6.8%	3.1%	1H EBITDAX of US$2.3bn missed consensus of $3.1bn due to inventory losses and higher corporate costs. The highlight was on capital management, with 1H DPS at 15.1cps beating expectations of 11cps. Production and cost guidance for CY23 were reaffirmed and compared favourably to consensus.
Woodside Energy Group	WDS	Full year	-15.4%	1.5%	2H EBITDA of US$7.07bn was ~8% below expectations due to higher royalties and increased restoration expenses, partially offset by lower shipping costs. CY23 production and CAPEX guidance was reaffirmed.
Lynas Rare Earths	LYC	Half year	-23.9%	-6.2%	1H23 EBITDA of $189m below consensus ($198m) on higher than expected input prices. No dividend was declared, inline with expectations. Importantly, LYC maintained guidance on the Kalgoorlie facility completion, with a target date of 4Q FY23 (before the closure of the Lynas Malaysia cracking and leaching facility).

Data as at 7/3/2023.
Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

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

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Wilsons contact

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

greg.burke@wilsonsadvisory.com.au | +61 2 8247 3118

www.wilsonsadvisory.com.au