WILSONS

Defensive Growth: Growth the Best Form of Defence

Our weekly view on Australian equities.

15 March 2023

MW Defensives, OW Growth Defensives

Last week gave investors a sneak peek into the type of tail event that can happen when central banks tighten to the extremes we have seen over the past 12 months.

Silicon Valley Bank (SVB) looks reasonably contained in terms of geography (US) and in terms of niche (venture capital/ tech), but shows how quickly market sentiment can change.

We are not changing the portfolio due to the collapse of SVB, but the event highlights how important defensives are in a portfolio, especially in such uncertain times.

As we continue through this slowdown period, investors will have to navigate a period where economic and earnings growth could be vulnerable to downward revisions.

Over the past 12 months we have increased our weighting to defensives that we believe will be more resilient to increasing downside risk from a slowdown in the global and domestic economy.

On our mapping, defensives represent ~25% of the ASX 300, and the Wilsons Australian Equity Focus Portfolio is currently sitting around that balance at 24%.

Figure 1: The Focus Portfolio is overweight defensive growth

Source: Refinitiv, Wilsons.

The way we differentiate ourselves from the market on our defensives allocation is through the type of defensives we favour. Our preference is towards growth defensives (healthcare, consumer services) rather than low growth defensives (consumer staples, utilities).

Why Do We Prefer Growth Defensives?

Higher returns

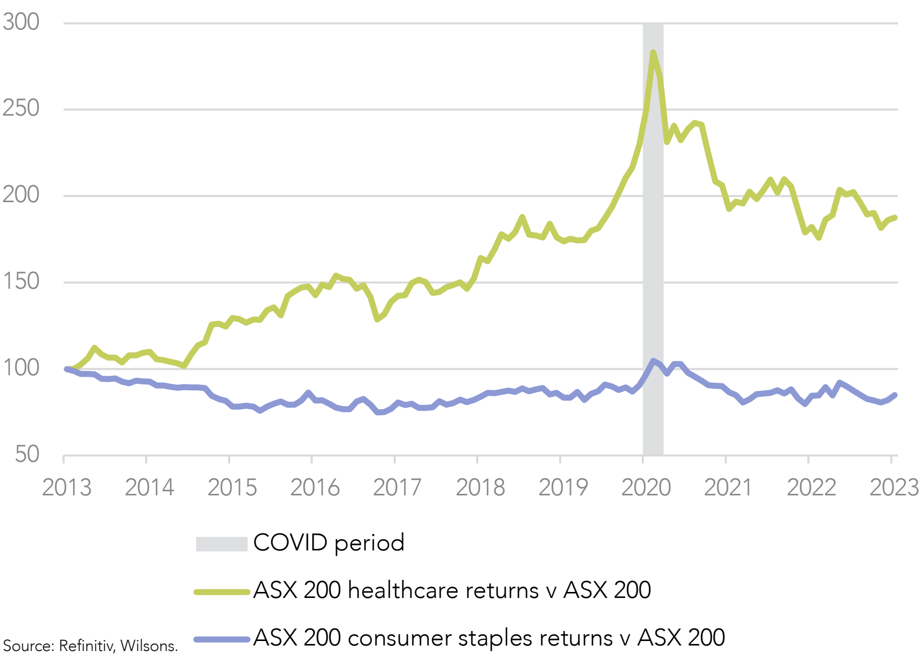
The Focus Portfolio holds a selection of high-quality, high-margin, defensive businesses with strong competitive advantages, pricing power, and relatively attractive long-term growth prospects.

We believe these companies are likely to grow their earnings faster than the market over the medium term, which should translate to outperformance over time.

Using the healthcare sector as a proxy for growth defensives, we can see the sector has outperformed the consumer staples sector (which contained Wesfarmers (WES) until 2019) and the broader market over a 10 year period. However, the sector has struggled during the COVID period, which we think is set to change.

Read our positive view on healthcare in Healthcare Sector - Overweight and in Good Shape

Figure 2: ASX 200 healthcare outperformed staples and the market over the past 10 years (while also providing downside protection)



Source: Refinitiv, Wilsons.

Case Study: CSL (CSL) vs Woolworths (WOW)

We take CSL vs WOW as an interesting case study to demonstrate how important growth is for investing. In 2013, CSL would have looked "expensive" relative to WOW, with a 12mth fwd PE of 21x vs 13x. If we invested $100k into CSL and WOW in 2013, by today, the 2013 ($100k) investment in CSL would be $525k or an 18% annual capital return (driven by earnings growth), while WOW would be at $142k or a 3.6% annual return (including dividends WOW would have generated a 5.4% annual total return).

The growth outlook for CSL still looks impressive, with an expected 24% EPS CAGR (FY23-FY25). WOW has an EPS CAGR of 7% on a PE of ~25x, which we struggle to justify based on this growth.

Delivering downside protection

We think growth defensives like CSL are valued more attractively (relative to their growth outlook) than the low- growth defensives. Still, like ultra-defensives, these companies should also demonstrate relatively resilient earnings through the economic cycle, providing protection against a slowdown, recession or tail risk event.

This is reflected in their low market betas as these stocks are typically less volatile than the market.

Valuations reasonable in the light of growth profile and quality of earnings

While these stocks offer higher growth, they come at higher valuations relative to the market. These stocks should have a low correlation to the broader economy. So, while valuations look 'expensive' on a standalone basis, we think they are reasonable considering the global slowdown, quality of these earnings (acyclical and resilient) and their strong growth profiles.

Bond yields: headwind to tailwind

Valuations for growth defensives have come under pressure from rising bond yields. Stocks which are generally considered to be growth-oriented could benefit if inflation fades, central banks pivot and bond yields compress. Therefore, we want to be positioned towards these growth defensives that should benefit if bond yields continue to fall.

Figure 3: Market multiples at a given point in time don't show the whole story; CSL has considerably outperformed WOW over a 10 year view

Start 2013	CSL	WOW
Investment ($)	100,000	100,000
Price ($)	53.9	25.901323
EPS (12 mth fwd) ($)	2.6	1.9
Price-to-Earnings (x)	20.99	13.31
DPS (12 mth fwd) ($)	1.00	1.38
Spot forward dividend yield	1.9%	5.3%

Current (14/3/2023)	CSL	WOW
Investment	525,473	142,078
Price	283.23	36.8
EPS (12 mth fwd)	9.6	1.5
Price-to-Earnings	29.4	24.9
DPS (12 mth fwd)	4.05	1.09
Spot forward dividend yield	1.4%	3.0%

Source: Refinitiv, Wilsons.

Figure 4: Healthcare PE v consumer staples PE – healthcare premium looks reasonable when considering the potential growth. Premium now sits below the 5-year average

Source: Refinitiv, Wilsons.

Foundations of a Strong Portfolio

CSL (CSL), ResMed (RMD), IAG (IAG) and Cleanaway (CWY) all provide the focus portfolio with defensive capabilities.

They also all fit the mould of growth defensives, with strong growth profiles to match their higher-than-market-valuations while delivering lower volatility than the market.

Lotteries (TLC) a Winner

Our top defensive pick is **The Lottery Corp (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.

TLC may look expensive relative to its growth profile, however, we believe the consensus earnings are too pessimistic. The increasing penetration of digital channels should lead to higher margins than consensus. For example, the 1H23 EBITDA margin of 21.3% is higher than the FY25E margin of 21.1%, which we think is too conservative.

Figure 5: Stock valuations that reflect growth prospects are worth a premium

Source: Refinitiv, Wilsons.

TLC's monopoly on lotteries in Australia further contributes to the higher multiple.

Defensive Opportunities

We have two other opportunities that may be of interest to investors with a more defensive risk profile.

Ramsay Health Care (RHC)

Wilsons Research: Overweight rated

Ramsay Health Care is a private hospital operator in Australia, Asia, the United Kingdom and France. It operates large metropolitan facilities, veterans' hospitals, rural centres, psychiatric units and day surgery/clinics. Domestically, Ramsay is engaged in a program of brownfields expansion, looking to add capacity to service an ageing population. Abroad, Ramsay looks to acquire hospital groups and implement its own operating style and margin discipline.

Recovery in elective surgery after COVID

We view RHC as a 'quality defensive'. Notwithstanding the unprecedented impacts of COVID-19 lockdowns, the underlying patient demand for private hospitals is typically resilient through the economic cycle given non-elective care is an essential household expenditure item, while even elective procedures are considered relatively non-discretionary compared to most other household expenses. We believe RHC will continue to see patient volumes recover in a post-COVID world.

Wilsons healthcare analysts' forecast an EPS CAGR of 36% (vs consensus of 26%) between FY23E and FY25E, driven by a recovery in surgeries, strong underlying utilisation trends, raised prices for payers, dwindling COVID costs, and continued brownfield activity.

Valuation supported by growth/defence and underlying assets

RHC trades on a 12-month forward PE multiple of 29.2x, which we think is very attractive relative to the strong EPS growth expected over the medium-term. This is based on Wilsons' 3-year EPS CAGR, RHC trades on a compelling PEG (PE / EPS CAGR) ratio of just 0.7x (vs the ASX 200 at ~1.5x).

RHC's portfolio of owned real estate assets – which have a book value of around $5bn as of 31 December 2022 – add to the defensiveness of the business and serves as a valuation floor.

Treasury Wine Estates (TWE)

Treasury Wine Estates is a vertically integrated producer, marketer and distributor of premium-focused wine, which operates in more than 70 countries globally.

Wine demand is resilient over the cycle

TWE has both structural growth and quality defensive characteristics. On the structural growth side of the equation, the business is poised to deliver meaningful earnings growth as it executes its premiumisation strategy which is poised to drive material margin expansion over the medium-term. On the quality defensive side of the equation, wine consumption is typically relatively resilient through economic cycles.

Bottled-up demand from China becoming a tailwind

Prior to COVID, Chinese tourists were TWE's top market for high-margin duty-free and cellar door products (especially those from Penfolds). There may be a material earnings upside from the rapid reopening of China's economy and a surge of Chinese tourists coming to Australia.

Uncorking China-Australia relations

TWE is leveraged to China's re-opening. In recent years, the business has been heavily impacted by souring Sino-Australian relations when China placed tariffs of more than 200% on Australian wine exports in late 2020. Prior to then, TWE was the #1 wine importer in China and >40% of its EBIT came from Asia (predominantly China). TWE was relatively successful in re-allocating its products to other fast-growing markets which helped soften the hit to earnings.

Nonetheless, improving bi-lateral relations between Australia and China could see the market re-open for business for TWE. Recent dialogue suggests China may be willing to reduce or completely remove the tariffs on Australian wine with government officials stating they are 'willing to communicate on some technical issues in bilateral trade which are of concern to both sides'.

Therefore, a more constructive backdrop for bilateral trade, coupled with the loosening of China's COVID restrictions earlier this year, could drive a meaningful earnings upgrade for TWE which is not yet priced by the market.

Growth and defensive characteristics justify valuation

From a valuation perspective, TWE trades at a 12-month forward PE multiple of 22.4x, which offers compelling value considering its 3-year consensus EPS CAGR of 15% where we see material upside if China loosens its restrictions on wine imports.

Disclaimer and Disclosures

Recommendation structure and other definitions

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

Disclaimer

All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

Wilsons Australian Equity Focus Portfolio (Focus Portfolio) is a portfolio of the Investment Strategy Group's (ISG) preferred companies. The Focus Portfolio aims to hold around 25-30 companies, largely taken from the S&P/ASX 300. Stocks may be substituted at any time at the discretion of the ISG. Performance numbers around the Focus Portfolio are unaudited, and should be used only as a guide to indicate returns if investors were to follow the Focus Portfolio. For further information please contact your Wilsons Advisor.

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance. All investing carries risk.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 may have participated in some capacity with regard to capital raisings for some of the companies mentioned in this article. To manage any conflicts of interest with Wilsons Research, full disclosure on any relevant corporate transaction may be found on our website.

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