WILSONS

How Long Before a Vaccine can Restore Earnings?

Our weekly view on Australian equities.

19 November 2020

Differing Speeds of Recovery

News of early phase 3 vaccine trial results from both Pfizer and Moderna have, for the first time in 9 months, given the market a visible path out of COVID-19 lockdowns and economic dislocation.

While this is undeniably good news from both a health and economic perspective, investors across different sectors in the Australian market have wildly different views around when a vaccine will become effective from an earnings perspective. We take a look into the market's assumptions around the speed of the recovery across different sectors.

Where sectors earnings have been COVID-19 impacted, there is a difference of 3 years between sectors that are expected to see an early earnings recovery and those expected to have a slower recovery.

For example, REITs are expected to recoup all the 'lost' earnings by FY22, while the market is particularly bearish on the travel-related sector, which is not expected to return to a pre-COVID-19 level of earnings until 2025. We believe the pace of earnings recovery needs to be taken into account when accessing the COVID-19 recovery plays.

In recent months, we have outlined the case for portfolio rotation into more cyclical sectors, with positive vaccine news providing the catalyst for a re-rating in cyclical stocks hit hard by COVID-19 impacts.

Read Is US Equity Market Dominance Set to Pause or End?

Since September, we have increased the Wilsons Australian Equity Focus to cyclical exposures by 15%, bringing the total exposure to 60%.

Read our report on Rotating Further to Cyclical Recovery.

We have lifted the banks from underweight to overweight, increasing exposure to energy via BHP Billiton (BHP), Santos (STO) and Worley (WOR). Domestic cyclicals have been increased with Seven Group Holdings (SVW) upweighted.

Read more on Assessing our Exposure to a Cyclical Recovery.

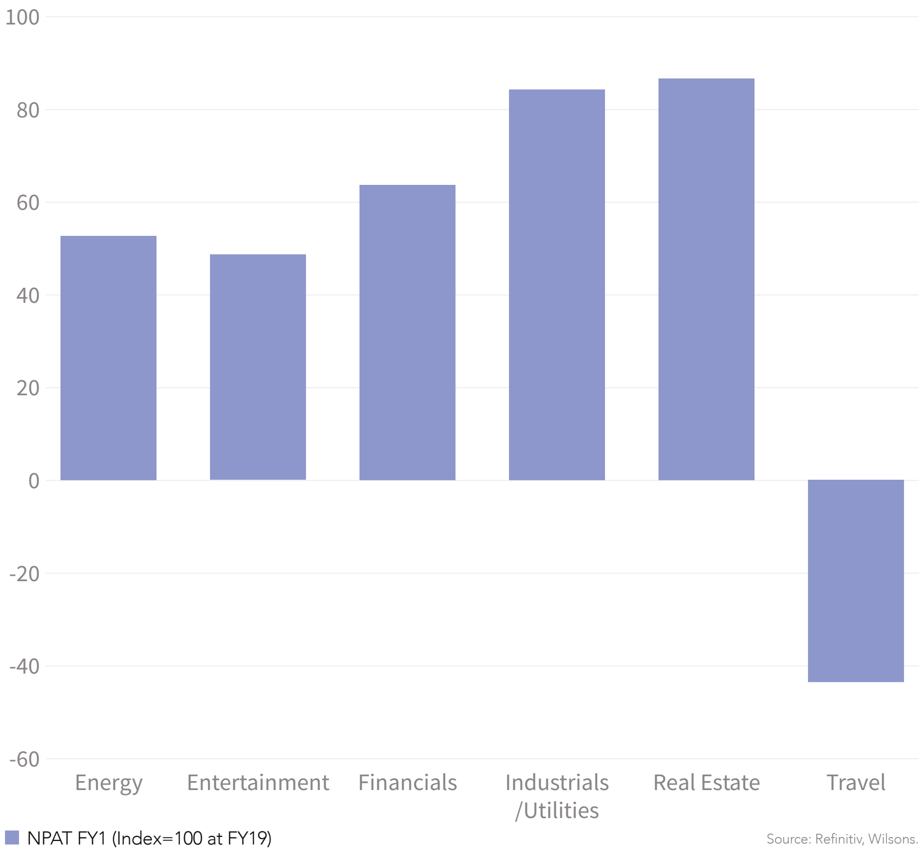
The Extent of 'Lost' Earnings

Within the S&P/ASX100, around half of all companies (a little bit more by market cap weight), have seen earnings negatively impacted by COVID-19.

In FY21, for those companies still showing a loss of earnings (net profit after tax - NPAT) relative to FY19, the average loss is ~30%.

AGL Energy (AGL), Woodside Petroleum (WPL), Flight Centre Travel Group (FLT) and Alumina (AWC) are forecast to see earnings down between 50% and 76% versus pre-COVID-19 levels. Whether it is lower electricity prices (AGL) or reduced demand for travel services (FLT), in most cases, COVID-19 will be the primary reason for the loss of earnings.

Exhibit 1: Sectors with a reduction in earnings estimates now versus pre-COVID-19



Source: Refinitiv, Wilsons.
Sector earnings rebased to 100 as 1 Jan, 2020.

Sector Vaccine Recovery Time Frames

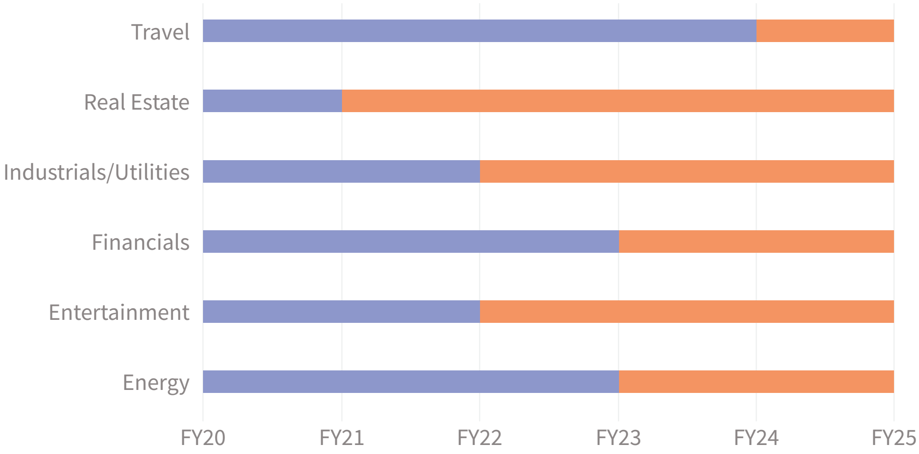
Only the REIT sector is expected to see earnings fully recover by FY22 at an NPAT level. While many REITS have 'lost' between 3-12months of rent, the retail exposed REITs are likely to see rent collection recover reasonably quickly as domestic spending accelerates in shopping centres post-re-openings. Office REITs may take a little longer to see rent improve given the large Sydney and Melbourne CBD exposures.

Both the industrials and entertainment sector are likely to take until FY23 to recover 'lost' earnings, with the length of time service-based businesses like Crown (CWN) and Star Entertainment (SGR) were closed extending the recovery time frame.

The financials, energy and travel sectors are not expected to see an earnings recovery until FY24 or 1HFY25, though we think the market may be too pessimistic on the speed of recovery here. A fast-tracked global vaccine rollout during 2021-22 has the potential to bring forward activity levels and earnings expectations, and we are closely watching evidence on this front.

Financials could potentially deliver a faster earnings recovery, primarily due to lower bad debts and unwinding of these provisions. Sector pre-provision profit levels (ex-remediation/one-offs) are forecast to remain largely flat over the next 3-years. The combination of large provisions, less actual bad debts, and strong capital positions in an environment of improving sentiment/ confidence could well see banks begin returning capital to shareholders.

Exhibit 2: How long before earnings recover for negatively impacted S&P/ASX 100 sectors?



Source: Refinitiv, Wilsons.
Earnings = NPAT. We have rolled consensus earnings using implied run-rates for sectors where earnings recovery is beyond FY23.

The Impact of Share Dilution

Twenty percent of the S&P/ASX 100 companies have raised equity capital over the course of 2020, primarily to protect the balance sheet from the COVID-19 induced earnings collapse. The weighted average share dilution was material at 7%, but significantly less than experienced in the GFC.

Flight Centre was an extreme case, needing to issue almost its entire share base. The implication going forward is NPAT would have to be double the FY19 level for earnings per share (EPS) to match FY19. This is less of an issue for new investors, but it does imply that a return to pre-COVID-19 levels of NPAT earnings, evaluated on the same price-to-earnings ratio (PER), would result in the share price of ~$22, not the $44 of late 2019.

Exhibit 3: S&P/ASX 100 company share dilution in 2020

Company	Dilution
Flight Centre Travel Group	97%
Oil Search	36%
Qantas Airways	26%
LendLease Group	21%
Vicinity Centres	21%
Sydney Airport	19%
Incitec Pivot	19%
Downer EDI	18%
Qube Holdings	16%
Ramsay Health Care	13%

Company	Dilution
QBE Insurance Group	13%
Bank of Queensland	12%
Tabcorp Holdings	9%
Challenger	9%
Atlas Arteria Group	8%
Bendigo and Adelaide Bank	7%
Orica	7%
National Australia Bank	4%
Westpac Banking Corp	4%

Source: Refinitiv, Wilsons.
S&P/ASX share dilution 4% or greater since 1 Jan 2019.

The Impact of Dilution on the EPS Recovery

EPS is always more important for share prices than NPAT, as EPS takes into account the number of shares outstanding. As a consequence, dilution is an important concept to consider.

The implication is that while earnings (NPAT) may recover, EPS recovery is likely to take longer due to dilution impact.

We can see by FY20, earnings across the recovery sectors are -16% below FY19 levels, but EPS levels are -23% below. This effectively pushes the length of the recovery in EPS to FY19 by just over 1 year to 2024 versus the recovery in NPAT earnings. For the travel sector, given the dilution is so large, the recovery in EPS is pushed out many years.

Cyclical Recovery Plays in a Portfolio Context

The large overriding thematic for the Australian market is the vaccine discovery and deployment story, which in our view, overwhelms the increase in COVID-19 cases and economic lockdowns in the Northern Hemisphere.

As further evidence builds of discovery and deployment, we may look to increase exposure within the context of a quality/growth style of the Focus List.

There are two key elements here at play which will likely see a number of these cyclical recovery companies outperform the index in the near-term:

1. The extreme disparity between growth and value valuations at present. Even a partial 'mean reversion' of this valuation gap would likely see outperformance of cyclical recovery share prices.
2. Signs that earnings have stabilised, or better yet, early signs of earnings upgrades emerging in cyclical recovery plays. Consensus earnings revisions for cyclical recovery companies were flat over the last month. At the worst, negative revisions of >50% occurred during the April-June period.

Exhibit 4: Price change vs movements in NPAT, EPS and dilution

Sector	Price Change	NPAT COVID-19 Impact	COVID-19 Impact EPS Change	Dilution
Energy	-35%	-26%	-30%	-5%
Entertainment	-14%	-10%	-13%	-2%
Financials	-19%	-15%	-17%	-4%
Industrials/Utilities	-19%	-4%	-2%	-4%
Real Estate	-21%	7%	-10%	-6%
Travel	-36%	-49%	-64%	-48%
Average	**-24%**	**-16%**	**-23%**	**-7%**

Source: Refinitiv, Wilsons.
Price change 1 Jan 2020 versus 17 November 2020. NPAT/EPS FY2/FY-1.

We have not explored valuation differentials deeply in this note. At least in the near-term, we do not think it matters to a great degree for the market given the imprecision involved with earnings. Looking out further to FY22 and FY23 can perhaps provide a more useful picture.

Playing the Earnings Recovery

We have significantly pivoted the Focus List towards cyclical recovery plays, with 60% of the Focus List tilted towards companies which can benefit from the cyclical recovery.

To date, we have played the more certain short to medium-term dated recovery companies – entertainment (Aristocrat Leisure Limited - ALL), banks (ANZ Banking Group - ANZ, Commonwealth Bank - CBA, National Australia Bank - NAB), energy (Santos - STO, Worley - WOR) – avoiding the longer-dated, more uncertain (and more volatile) recovery sectors like travel.

We are underweight REITs (Goodman Group - GMG Focus List is a COVID-19 beneficiary) and industrials from an earnings recovery perspective. Industrials like Brambles Limited (BXB), Downer Group (DOW) and Telstra Corporation (TLS) are all looking interesting given earnings recovery potential. REITs like Lend Lease Group (LLC), Mirvac Group (MGR) and Scentre Group (SCG) potentially all stand to benefit from economic reopening and cyclical recovery.

Exhibit 5: Focus List recovery play metrics

Focus List Companies	Price ($)	EPSg % (FY1-FY3)	EPS 1 Mth Rev. % (NTM)	PE (NTM)	ROE (NTM)
Worley	11.9	15%	-1%	16.6	6%
Santos	6.1	43%	-1%	19.5	6%
Aristocrat Leisure	33.3	47%	1%	26.7	23%
NAB	21.8	10%	1%	14.5	8%
CBA	75.4	9%	3%	17.8	10%
ANZ	21.7	10%	5%	13.2	8%
Aurizon	4.1	8%	0%	14.9	12%

Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

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

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Wilsons contact

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

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

www.wilsonsadvisory.com.au