WILSONS

Is a Rising A$ a Headwind for Offshore Earners?

Our weekly view on Australian equities.

04 November 2021

A Stronger A$ not Something to Fear

The A$ appreciated markedly through October 2021, rising almost 5 cents to 0.75 A4/US$ as local bond markets repriced the prospects for local interest rate increases over 2022.

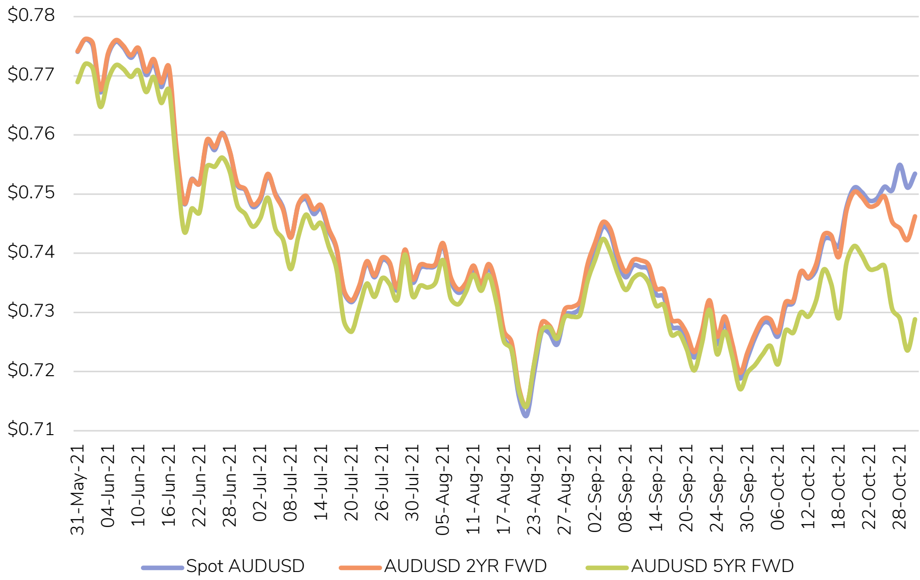
Australian equities, on the other hand, underperformed global equities through October (flat vs +5% for MSCI world index) as local investors became fixated on whether the combination of rising interest rates and the A$ would quash both earnings and valuations.

We would not rule out the prospect of the A$ appreciating further over the next 12 months, perhaps to as high as 0.80, as both Australian economic growth and corporate earnings improve in absolute terms as well as relative to other regions.

Read Cycle Maturing but Still Plenty of Life.

Does a rising A$ create a headwind for the equity market? Our short answer is that headwind is not insurmountable, given the earnings recovery thematic is likely to still win the day. But there are also several underlying reasons around the composition of the Australian market as to why investors should not be afraid of a potentially stronger A$ into 2022.

Exhibit 1: Spot A$/US$ remains well ahead of both 2yr and 5yr FX forward rates

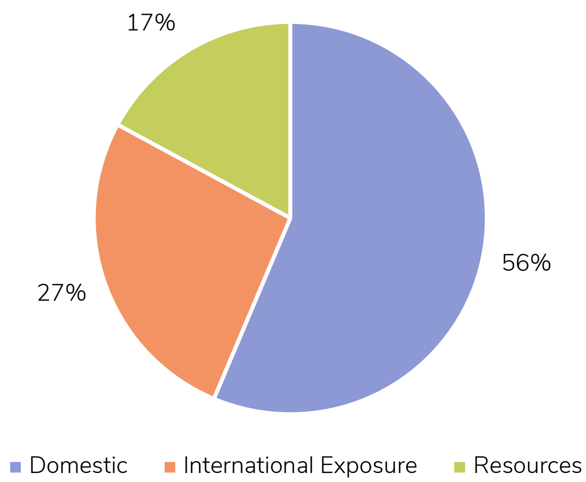


Source: Refinitiv, Wilsons.

Level of Offshore Earnings Exposure

The composition of the Australian market has a significant influence on why a rising A$ should not be considered a major threat to both earnings or market performance. We estimate just over half of all earnings across the S&P/ASX 100 is domestically sourced.

Exhibit 2: Offshore revenue exposure of the S&P/ASX 100



Source: Company Data, Refinitiv, Wilsons. Market Cap weighted. 2021 data used.

The major banks and the supermarkets of Coles (COL) and Woolworths (WOW) are good examples where companies have no offshore revenue exposure (we include NZ revenues as domestic revenues throughout this note).

A higher A$ is broadly neutral/slightly positive for this group of companies (higher A$ can reduce costs in some cases).

Companies with direct offshore sourced revenues make around 25% of the market. This is typically from global leaders within the ASX 100 with large offshore operations.

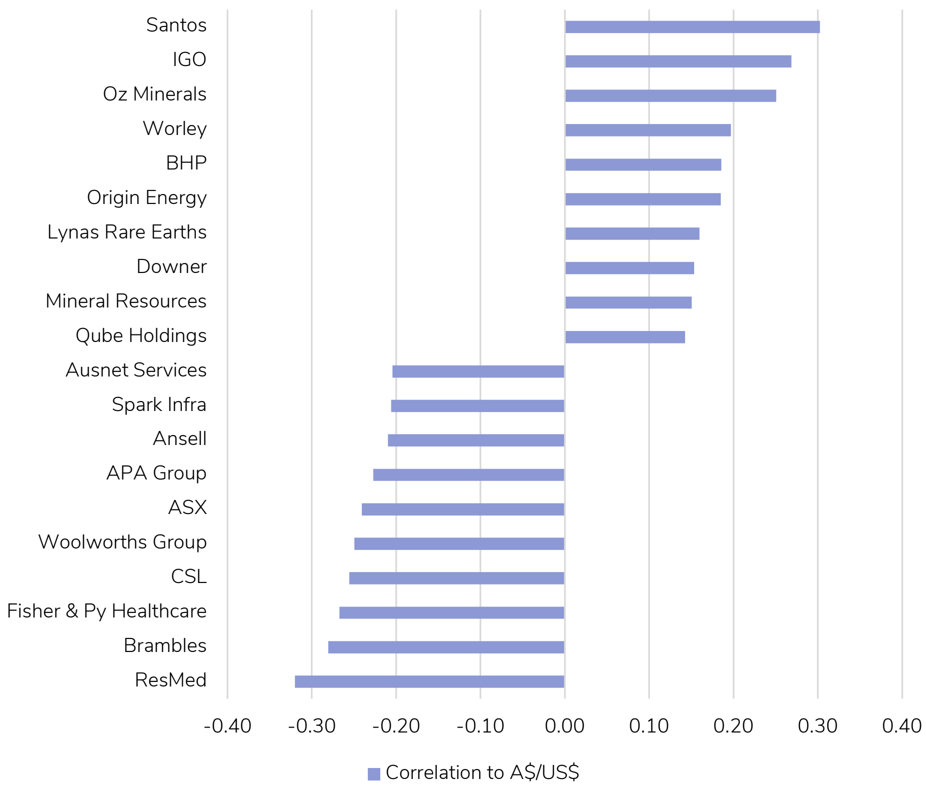
Macquarie Group (MQG), select industrials like Aristocrat (ALL), James Hardie (JHX), SEEK (SEK) and much of the healthcare sector all have a significant component of their earnings sourced from offshore. A rising A$ implies translation risk as US$ denominated (US$ is the predominant offshore exposure) earnings are brought home.

Resource Sector Typically Positively Correlated to the A$

The resources sector is a little different. A higher A$ at face value is a negative due to the translation risk since commodities are generally priced in US$. However, this ignores the positive correlation typically seen between the A$ and commodity prices. For producers like BHP (BHP), Rio Tinto (RIO) and energy companies like Santos (STO) and Woodside (WPL), the earnings leverage to higher underlying commodity prices swamps any translation impact from a higher A$.

We see around 75% of the market as either neutral or positively exposed to a higher A$, with only the offshore earners at 25% being a drag. Partly insulating the offshore earners is the higher level of earnings growth they typically have relative to domestic companies. For simplicity of the analysis, we focus solely on the A$/US$, the predominant currency exposure of S&P/ASX 100 companies.

Exhibit 3: S&P/ASX 100: Top 10/bottom 10 share price correlations to the A$/US$*



*Correlation coefficient weekly observations since 2011

Source: Refinitiv, Wilsons.

Share Price Sensitivity to the A$

We have measured the share price sensitivity of ASX 100 companies to the A$/US$ over the past 10 years. Correlations both positive and negative are relatively low, being no higher than 0.3.

Resource and energy companies dominate the positively exposed top ten positions. In the bottom ten, a mixture of infrastructure/utility-like names and selected offshore earners dominate.

Utility names make an appearance due to second-order influences. A rising A$ is often accompanied by rising global growth expectations, leading investors to rotate out of defensives and into cyclical names. The opposite hold when global growth expectations are weakening.

What the 2016-18 Experience Tells Us

From early 2016 to 2018, the A$ rose from 0.69 to 0.81 as global growth expectations rose. Resources companies saw both earnings and share prices rerate significantly, up over 100%.

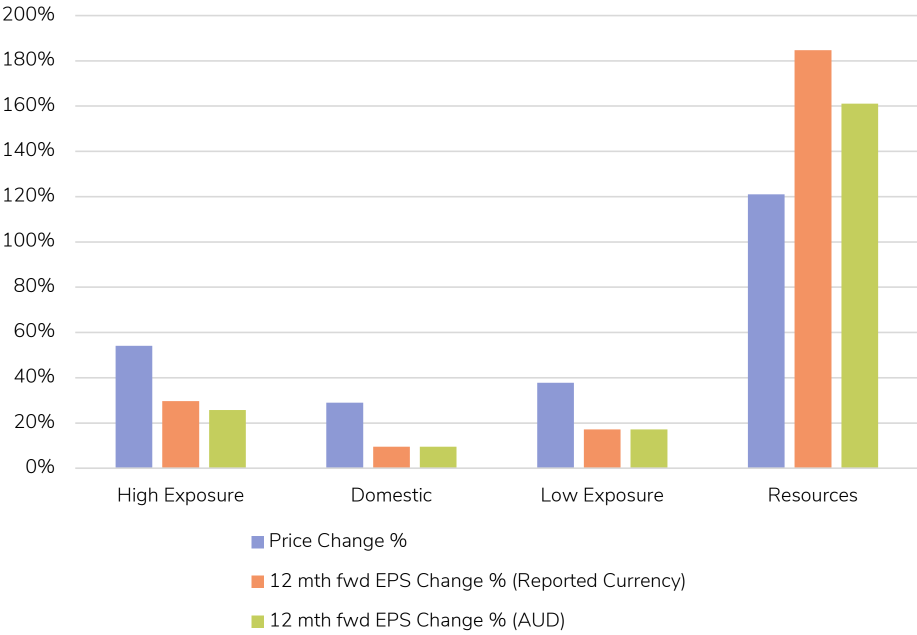
Within the international exposure bucket, the highly exposed companies saw both the strongest earnings and share price performance, despite the greater headwind the higher A$ posed. Investors tend to discount the FX impact, as ultimately it is transitory (A$/US$ tends to mean-revert), and underlying earnings growth overwhelms the FX impact.

High exposure offshore earnings still offer the highest levels of earnings growth into FY23E

Looking at growth rates within the offshore earners, those with the highest level of exposure have both the highest level of revenue and earnings growth. This points to the global opportunity set for many companies and provides a degree of protection should the A$ continue to rise towards 0.80, given the base level of earnings growth is already superior.

Outside of travel stocks (loss-making, expected to move to profit), the companies with the strongest expected level of earnings growth between FY21 and FY23 in the high exposure bucket include IDP Education (IEL), WiseTech Global (WTC), Orica (ORI), SEEK (SEK) and A2 Milk (A2M).

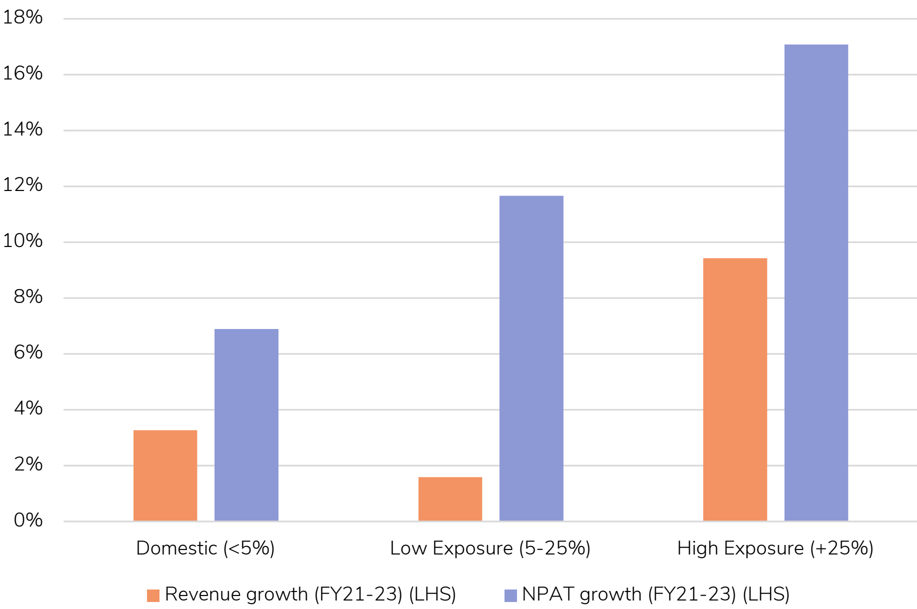
Exhibit 4: High exposure offshore companies performed strongest during the 2016-18 A$ rally*



*2016-2018 period, A$/US$ rallied from 0.69 to 0.81. A simple average change in price and forward earnings.

Source: Refinitiv, Wilsons.

Exhibit 5: Highly exposed offshore earners have the strongest revenue and earnings growth into FY23E



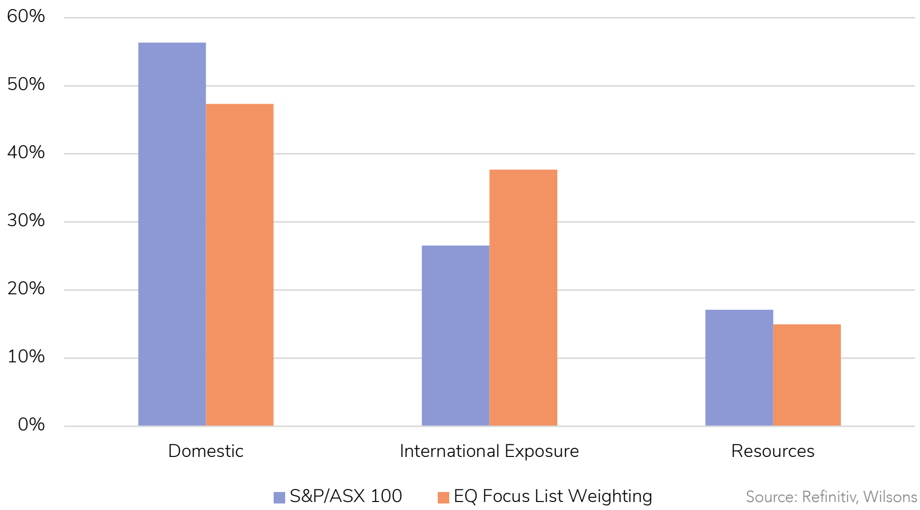
Source: Refinitiv, Wilsons.

Focus List Implications

The Wilsons Australian Equity Focus list notionally has higher exposure to offshore earners versus the market. We see earnings growth in key offshore companies as strong enough to be the larger influence on share prices over the 2022 period versus the potential impact of a higher A$/US$.

Key offshore earners we would highlight include; ALL, CSL (CSL), Goodman Group (GMG), JHX, MQG, ResMed (RMD) and SEK. Resource and energy names should do well relative to the market in a rising A$ environment.

Exhibit 6: Focus List currently has a 10 percentage-point higher exposure to offshore earners vs the market



Source: Refinitiv, Wilsons

While our base case is that currency continues to appreciate closer to 0.80 through 2022, an overshoot through 0.85 would likely become a relative performance issue for the Focus List.

We caution against getting too focused on upside risk cases at this juncture. Company management teams with offshore exposures always remind us it is not so much the level of the A$/US$ that impacts earnings growth, but the rate of change. Rapid moves in the currency, both up and down, can create havoc for earnings as management teams simply do not have time to change or introduce action to mitigate the impact.

Exhibit 7: Focus List exposures to offshore earnings

Company	Ticker	AUD Exposure	Price ($A)	Mcap ($b)	PE NTM (x)	Wilsons Comment
Communication Services						
News Corp	NWS	High Exposure	31.1	18.5	30.5x	International earnings - Largely translation impact
Seek Ltd	SEK	High Exposure	33.5	11.8	54.6x	International earnings - Largely translation impact
Telstra Corporation Ltd	TLS	Domestic	3.9	46.6	25.6x	Minimal FX impact
Consumer Discretionary						
Aristocrat Leisure Ltd	ALL	High Exposure	48.2	31.3	28.4x	International earnings - Largely translation impact
Energy						
Santos Ltd	STO	Resources	7.1	14.8	9.2x	Higher commodity price beneficary
Financials						
Macquarie Group Ltd	MQG	High Exposure	195.6	73.2	20.1x	International earnings - Largely translation impact
Insurance Australia Group Ltd	IAG	Low Exposure	4.5	11.9	16.1x	Minimal FX impact
Australia and New Zealand Banking Group Ltd	ANZ	Low Exposure	27.8	80.1	12.8x	Small benefit from lower offshore funding costs
Westpac Banking Corp	WBC	Domestic	23.1	87.2	14.0x	Small benefit from lower offshore funding costs
National Australia Bank Ltd	NAB	Domestic	28.2	93.3	14.4x	Small benefit from lower offshore funding costs
Healthcare						
CSL Ltd	CSL	High Exposure	308.0	139.6	43.6x	International earnings - Largely translation impact
Telix Pharmaceuticals Ltd	TLX	High Exposure	7.2	1.9	n/a	International earnings - Largely translation impact
ResMed Inc	RMD	High Exposure	35.3	51.3	39.8x	International earnings - Largely translation impact
Silk Laser Australia Ltd	SLA	Domestic	4.4	0.2	23.2x	Minor benefit lower COGS
Industrials						
Qantas Airways Ltd	QAN	Low Exposure	5.5	10.4	>100x	Indirect demand benefit, lower COGS
Seven Group Holdings Ltd	SVW	Domestic	21.6	8.0	11.2x	Minimal FX impact
Information Technology						
EML Payments Ltd	EML	High Exposure	2.9	1.1	19.4x	International earnings - Largely translation impact
Xero Ltd	XRO	High Exposure	153.6	23.1	>100x	International earnings - Largely translation impact
Afterpay Ltd	APT	High Exposure	121.7	35.4	>100x	International earnings - Largely translation impact
Materials						
James Hardie Industries PLC	JHX	High Exposure	52.0	23.3	26.1x	International earnings - Largely translation impact
BHP Group Ltd	BHP	Resources	35.6	181.3	7.9x	Higher commodity price beneficary
OZ Minerals Ltd	OZL	Resources	24.3	8.2	12.9x	Higher commodity price beneficary
Northern Star Resources Ltd	NST	Resources	9.0	10.6	19.1x	Higher commodity price beneficary
REITS						
Goodman Group	GMG	High Exposure	23.5	41.6	29.8x	International earnings - Largely translation impact
Healthco Healthcare and Wellness Reit	HCW	Domestic	2.2	0.7	n/a	Minimal FX impact

Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

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

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