MARTIN CURRIE AUSTRALIA

MARTIN CURRIE

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REPORTING SEASON WRAP: A RETURN TO THE 'OLD' NORMAL

While Omicron has dampened the speed of Australia's reopening, other serious thematics are also at play for the Australian companies reporting this February.

What will be the true impact on earnings and dividend outlooks from the impact of rising operating costs, shortages, rate rises, and margin pressures? Are we seeing a return to an old normal for inflation? And what does this mean for Value-style stocks?

Reece Birtles

Chief Investment Officer
Martin Currie Australia

Introduction

This time two years ago we had titled our reporting season wrap as "Society has changed". We were referring to the devastating bushfires in southeastern Australia and attitudes toward climate change, but little did we know about the impact that COVID-19 would have on our lives, Australian companies and the economy for the next 24 months and beyond.

While Omicron has dampened the speed of Australia's reopening in 2022, our analysis and 100+ meetings with company management has highlighted several thematics are at play for the Australian companies reporting this February.

This season, we saw what we are calling a "return to the 'old' normal", driven by **inflation**, **pricing power** dynamics creating a varying ability to pass on costs, and a shift between the market's desire for Growth towards **Value-style stocks**.

With these shifts, we are seeing significant opportunities for Value-style stocks to benefit as the Australian economy continues to strengthen, highlighting why now, more than ever, is the time to allocate to Value.

Contents

Our bi-annual reporting season paper will cover the following in finer detail:

Definitions

What we do each reporting season

On top of our fundamental analysis and company engagement on individual stocks, we have a framework to overlay an analytical top-down view of the reporting season's results for the stocks in the S&P/ASX 200 index.

This aggregated review allows us to judge the overall pulse of the market from the top down. We can then assess the themes across the market that would be 'hard to see' when looking at each company result in isolation and apply our insight at the stock and portfolio level.

Key definitions used in our top-down analytical review

Lead-in revision: the average change in broker consensus NTM forecasts in the three months leading into the season.

Surprise: the percent of companies where there is a >+/-2% difference between company reported results and broker consensus forecasts for the period.

Follow-on Revisions: the average change in broker consensus NTM forecasts after companies have reported their results.

Price reaction: stock price movement for the two days after a company reported their results.

Price to earnings (P/E) rerate: change in price during the season versus the change in broker consensus EPS forecasts over the same period.

"With these shifts, we are seeing significant opportunities for Value-style stocks to benefit as the Australian economy continues to strengthen highlighting why now, more than ever, is the time to allocate to Value."

Top-down analytical review

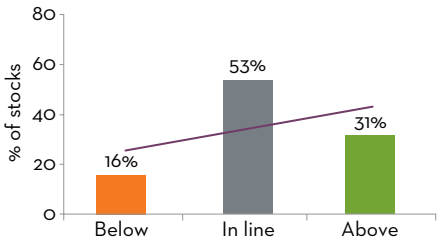
Strong lead-in EPS revisions setting a high base, and strong results off lower level of expected growth

After a strong August 2021, earnings per share (EPS) and dividend per share (DPS) expectations for Australian companies fell significantly on the back of Omicron variant concerns, supply chain disruptions and the expected impact of inflation on margins from higher input costs.

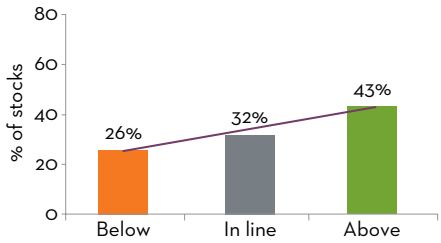
Despite this, expectations in the lead-in to February 2022 results were still well off the COVID-19 lows of 2020 and were again moving upwards thanks to expectations of reflation and rate rises.

Within this backdrop, actual results were much better than was expected (or feared) by the consensus brokers across the sales, EPS and DPS lines. Notably, 43% of companies beat EPS expectations by more than 2%, versus just 26% below.

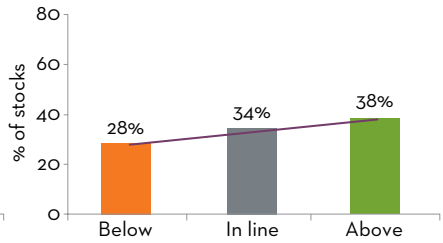
Sales surprise



EPS surprise



DPS surprise



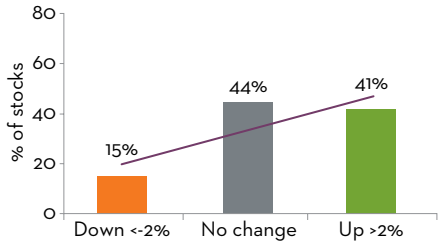
The main driver of company results strength was predominantly in the sales or revenue line, and we see that this has been due to very strong consumer conditions. Sales growth and nominal GDP are highly correlated, and this has been reflected in the ability of companies to pass on the cost increases that are coming though on to consumers that can easily pay.

Another point to note on the strength of consumers is the high savings rate that persisted throughout COVID-19 as we saw a reduction in spending on services (hospitality and tourism) and a lower 'pain spend'. This includes the cost of operating vehicles (i.e., petrol costs), insurance pricing, electricity prices, interest etc., all of which stayed low during COVID-19. Looking forward however, we would note that we see a more challenged outlook for pain spend given rising oil costs on the back of Russia/Ukraine conflict and rising interest rates.

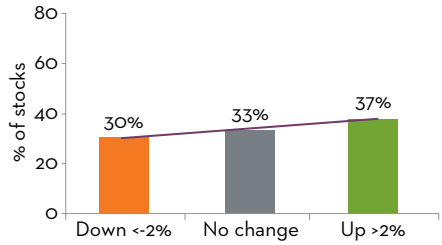
Post-result forecast revisions were solid, with Sales experiencing strongest upgrades in over a decade

In terms of how brokers updated their forecasts post-result, we saw that more companies received upgrades than downgrades across the sales, EPS and DPS lines. For sales in particular, the skew to upgrades was much better than the average over the past 10 years due to greater than expected pricing power of companies.

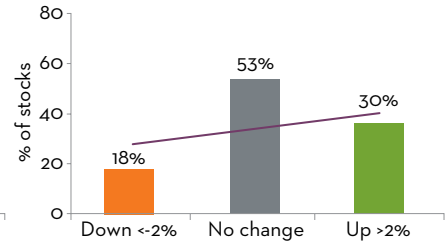
Sales revision



EPS revision

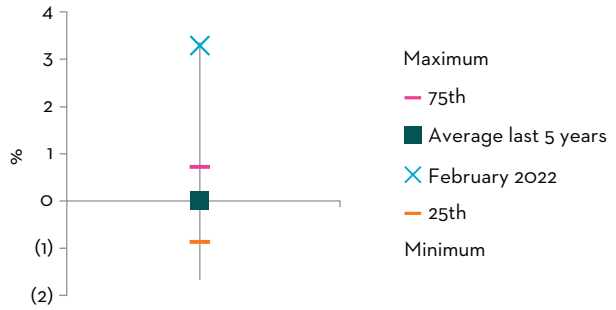


DPS revision



In aggregate, we usually see no marked change in the market's total EPS growth each season, however this season we saw a 3.3% upgrade, which over the last 5-year period is the second best, with last February being the best.

EPS revisions over the last 5 years



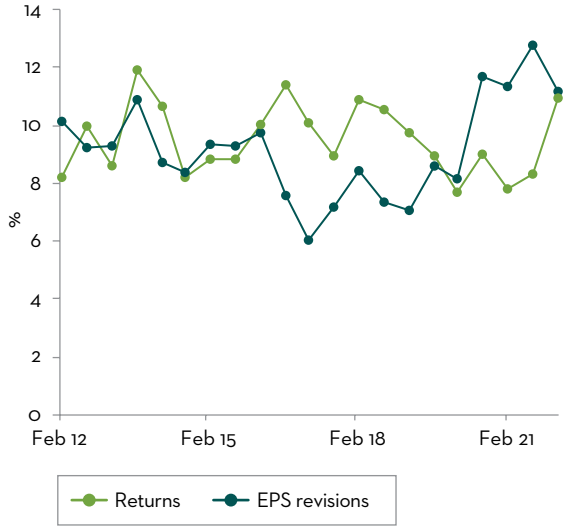
Dispersion in positive and negative forecast revisions continue

Since COVID-19 started to impact markets in 2020, we have continued to see a wide dispersion between the winners and losers in terms of their EPS revisions and returns. This has reached a level of more than 20% higher than the average dispersion pre-COVID.

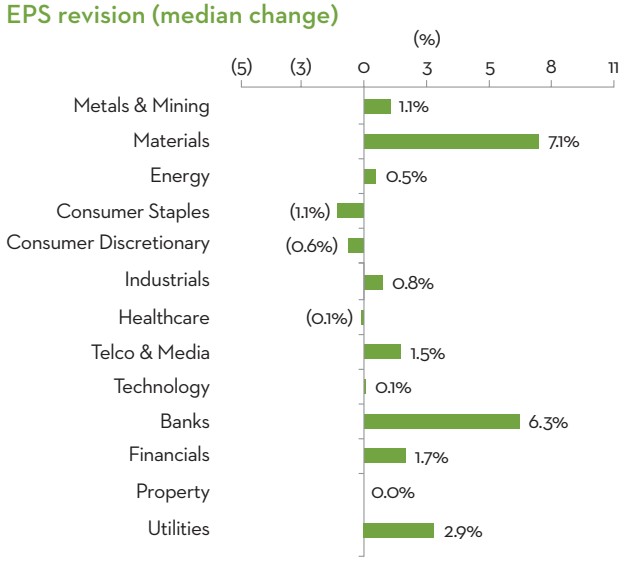
We would note that the composition of those winners and the losers in terms of returns have now started to change as we move into the recovery. Last year we were seeing the retail COVID-beneficiaries as the winners, while now, stocks positively exposed to the reflation dynamic and commodity prices are the ones being rewarded. These stocks are generally being found in sectors such as Resources, Financials, and Real Assets.

Looking at just the EPS revisions from a sector level, most sectors have seen net upgrades during the season, but the greatest positive skew has been in those sectors that are positive beneficiaries to rising inflation, high commodity and energy prices and higher interest rates.

Cross sectional variance



EPS revision (median change)



Sources and disclaimers for this section

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Source for all charts: Martin Currie Australia, FactSet; as of 28 February 2022. Chart data is for the S&P/ASX 200 Index unless noted otherwise. Calculated using the weighted average of broker consensus forecasts of each holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed.

Key fundamental themes from reporting season

Insight gained through company interactions

While the analytical and aggregated view of the reporting season's results provides a broader framework to judge what the street is thinking and doing, our fundamental analysis and company engagement of individual stocks allows us to do a deeper dive into the issues and strategies of each business.

Over the four-week reporting period, the MCA investment team conducted 100+ meetings with company management teams following the release of results, and this has helped us to refine our views on:

Inflation and the pricing power to pass through costs

As the inflation dynamic becomes more significant, the ability of companies to pass through input cost increases to their customers has been one of the most significant themes covered in meetings with management this reporting season. Companies that have done well here have either had in-built inflation protections for their revenue streams and supply chains and/or inflation leverage in their profit margins.

Chris Schade
Research Analyst

An example of a company whose results have shown their strength here is **Amcor.** While the packaging manufacturer has seen higher costs, they have managed to keep their sales heathy. The ability to increase prices without losing sales has meant that there has been less downward pressure on their profit margins and working capital, and revisions to growth expectations have been strong.

On the other hand, inflation has a much bigger impact on low sales growth/low margin businesses. A company like healthcare supplier **Ansell** has not had the pricing power to pass on higher input costs, and this has come through as a drag on sales and cashflow, as well as shrinking profit margins.

Another dimension of the inflation dynamic is that the type of company that has pricing power has also moved relative to the norm over the last decade. Until recently, service providers (typically the Growth-style stocks) were more likely to be able to increase prices, but now it is goods companies that appear to have a better ability to quickly pass through their input cost increases in a transparent manner. Conversely, it is now the services companies that are seeing higher costs in IT, compliance, wages, etc. but with less price elasticity they cannot push prices up and still maintain sales.

James Power
Research Analyst

Due to pricing power, and the essential nature of the goods sold, **Woolworths Group** and other supermarkets are doing a solid job of holding their gross profit margins, by passing through the rising cost of goods sold to their customers.

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Ashton Reid
Portfolio Manager – Real Assets

Accelerating inflation has been positive for **Scentre Group's** regional and super-regional shopping centres. They have high tenant occupancy, and rental contracts with CPI-adjusted lease renewal mechanisms. The company's February 2022 result also demonstrated their ability to maintain yields on smaller spends, supported by solid foot traffic across the company's centres.

Andrew Chambers
Portfolio Manager – Real Assets

Rising inflation has boosted infrastructure and utilities company's outlooks, especially those with CPI-linked contracts who are already seeing benefits of increased prices/revenues. For, example **APA Group's** operating expenses are a modest part of revenues, while revenue contracts are typically long-term take or pay with CPI-linkage mechanisms. So, as inflation increases, the dollar value of cashflows will increase, i.e., the company will be a net beneficiary of inflation.

Matthew Davison
Senior Research Analyst

Inflation, and subsequent rate risks are generally a positive for the Financials sector.

While higher rates will add pressure to households, provisioning is very conservative, and the **banks** (and their customers) have strong buffers. As a result, we see net interest margins (NIMs) will be a net beneficiary of rate rises and a welcome change to the pressure that low rates put on NIMs.

Insurers such as **Medibank Private** are also positively leveraged due to their ability to increase premiums under regulatory price rises.

Labour shortages

Looking at wages as one of the growing costs, we see that this is due to the labour shortages that we are now seeing both in specialist (programmers, software engineers etc) and low skill areas. This is truly a flow on effect from the lack of migration during COVID-19, and this tight labour market pressure is being reported by management teams we have met across most sectors.

James Power
Research Analyst

Companies that have been impacted here include **Ingham's Group** and **G8 Education** who have traditionally been reliant on new migrants for a large part of their workforce. Supermarket workforces have also been impacted by the lack of international students. Omicron has caused some temporary cost pressures for businesses such as **Woolworths Group** and **Coles Group**, flowing from additional overtime and casual labour to cover sick staff, particularly during January.

Patrick Potts
Research Analyst

Companies such as **Bravura** and the 'buy now, pay later' (BNPL) stocks such as **Zippay** have seen real issues with finding IT staff and filling vacancies, as have companies like **Domain Holdings Australia**. On the other hand, the tight labour market has been a positive for **Seek's** outlook and they have reported a growth in advertised salaries on their site over 2021, which is in alignment with the wage cost pressures that our companies have been reporting.

More positive COVID-19 outlooks

Omicron has had a significant impact for many companies over the last few months, but we are now hearing more optimistic commentary from management on reopening, at least for the east coast of Australia. Western Australia and New Zealand continue to see impacts, but companies can take their east coast learnings to reduce these impacts.

With travel barriers coming down, the appetite for travel will come back quickly, as will demand for COVID-exposed services more generally, such as retail.

Ashton Reid
Portfolio Manager – Real Assets

For example, **Vicinity Centres** has reported their rental collection, re-leasing spreads and the underlying retail sales of their tenants has recovered rapidly over the last few quarters, and retailers are signing up for mall space with a view to looking past short term COVID-19 risks.

Chris Schade
Research Analyst

On the travel front, **Flight Centre Travel Group** stands to benefit materially from border reopening and the pent-up demand from consumers for domestic and international travel as well as a structurally improved cost base and material account wins through the pandemic in its corporate travel segment.

> "Omicron has had a significant impact for many companies over the last few months, but we are now hearing more optimistic commentary from management on reopening, at least for the east coast of Australia."

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Impact of Russia/Ukraine conflict

While the invasion of Ukraine by Russian troops occurred after most of our meetings with company management had concluded, we would highlight that the situation will likely have an indirect impact on demand for Australian sourced commodities but will also exacerbate the impact of inflation.

Even before bans on Russian oil exports, globally there has been already a shortage in the supply of oil, as much of the capex by the majors in the energy sector has been directed from new drilling to focus on lower carbon alternatives. This means that oil price pressures are not going away quickly, and this will likely impact consumer confidence over time. Goods shortages also mean that inflation controls via higher rates will be less effective.

The Russia/Ukraine conflict, and subsequent trading bans for Russian stocks, has also highlighted the need for investors to consider ESG issues from both a stock level, but also the country level. In terms of country risk, Australia can be considered a safe haven in this type of environment compared to other markets.

Michael Slack
Head of Research

For example, demand for **Aurizon Holding's** coal transport services will likely increase, as will demand and/or prices for other agricultural products such as wheat (benefiting **Aurizon**, **GrainCorp**, **Elders**), ammonia and phosphate (**Incitec Pivot**), aluminium (**South32** and **Alumina**), oil and gas (**Woodside Petroleum**) that were previously sourced from Russia.

Sustainability themes

Finally, Sustainability and ESG issues also continue to be front and centre in our conversations with company management.

In particular, with regard to the decarbonisation/energy transition theme, we have been pleased to see that many companies have moved from simply talking about net zero targets towards actual action and spending plans. However, we believe that the level of capex spend in Australia and globally is not yet anywhere close to the additional US$3.5 trillion a year estimated by McKinsey that is required globally to reach 2050 net zero targets[1].

Will Baylis
Portfolio Manager – Sustainable Equity

We are seeing a great deal of capex/M&A in the resources and energy sectors. During reporting season **Woodside Petroleum** announced capex plans of A$5b for hydrogen in second half of decade. **BHP Group** also discussed their planned A$4b spend on decarbonization of business. Companies such as **Worley** and **Monadelphous Group** are positively exposed to the decarbonization spend dynamic, but the large projects are just still in the early stages.

James Power
Research Analyst

We expect **Monadelphous Group** to play a key role in the coming wave of decarbonisation spend as the push of global energy supply chains toward increased renewables generation and battery technology continues to gather momentum. The company has a strong pipeline of work which has faced some slowdown related to border closures and lack of migration. These headwinds are expected to lift as COVID-19 restrictions are eased, which should open up capacity for Monadelphous going forward.

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[1]Source: McKinsey Sustainability, "The net-zero transition: What it would cost, what it could bring", available from https://www.mckinsey.com/business-functions/sustainability/our-insights/the-net-zero-transition-what-it-would-cost-what-it-could-bring

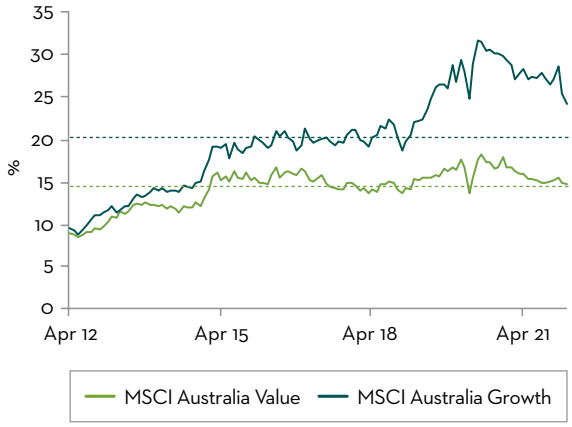
Implications for investors in Australian equities

Value spreads remain attractive

It is no secret that the last 5-10 years has been hard for managers adhering to the Value style. The MSCI Australian Value and MSCI World Value Indices have significantly underperformed their respective broader markets while the style has been out of favour. This was due to falling interest rates, sub-trend economic growth, and deflation allowing a premium to be placed on Growth stocks.

The valuation gap between Australian Growth and Value stocks has been stark in terms of the Price to Earnings ratio, and much larger than it has been historically. Despite the price of Australian shares reaching record highs, the P/Es of the two styles had been moving at very different paces. It is important to say that it wasn't that Value had been getting cheaper, it was that Growth had been getting much more expensive relative to its long-term average.

MSCI Australia style indices P/E ratios (NTM)



Over the past few months, Growth stocks have seen quite severe price reversion as the economic reopening gathers momentum. We have now seen a significant turn in the performance of Australian (and global) Value stocks, many of which will benefit from higher rates and reflation.

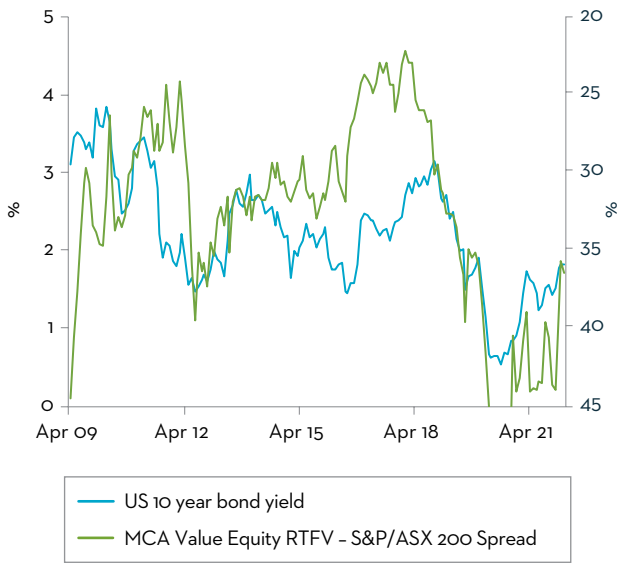
During reporting season in particular, we saw that broker EPS revisions for the cohort of high P/E stocks were downgraded more than low P/E stocks, which has caused their P/E ratios to re-rate significantly. On the other hand, the lowest P/E stocks (typically commodity, energy, financial sector stocks) saw more upgrades to EPS revisions and better price reaction.

Given the correlation between Value and GDP growth, these upgrades to typical Value stocks are also now starting to reflect their superior sales growth expectations, pricing power and stronger earnings outlook versus a flatter outlook for typical Growth stocks.

Australian Value stocks are particularly well-placed to do well in an inflationary environment relative to US or global stocks due to the Value-tilted nature of the Australian market. The US is more leveraged to the tech-led growth thematic, while Australia has very high-quality financials which will benefit from rising rates, and resources which will benefit from the Russia disruption and the demand for net zero. Value opportunities can be found across a range of Australian sectors, industries and stocks, and highlights why now, more than ever, is the time to allocate to Value.

Wide Value spreads have been a good predictor of future Value style returns. We have seen strong Value returns already in January and February, and the start of a narrowing in the valuation gap. We do believe that this is just the beginning and that Value-style stock's prices have yet to fully reconnect with the pace of world economic growth and inflation.

10 year bonds and value spreads (inverted)



We are seeing significant opportunities for Value-style stocks to benefit as the Australian economy continues to strengthen, highlighting why now, more than ever, is the time to allocate to Value.

The MCA Value Equity strategy provides investors with a diversified exposure to our highest conviction stock ideas with Valuation potential, while balancing risks through our focus on Quality & Direction.

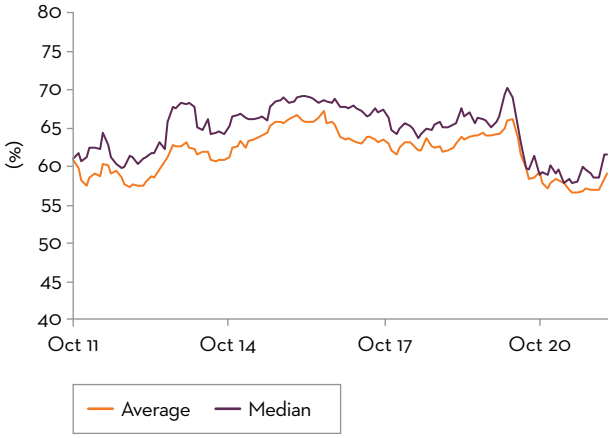
Income outcomes to flow through as recovery matures

For income-focused investors such as retirees, we understand that that the stability of the dividends is paramount to their standard of living. Given rising inflation, a growing income stream is more important than ever.

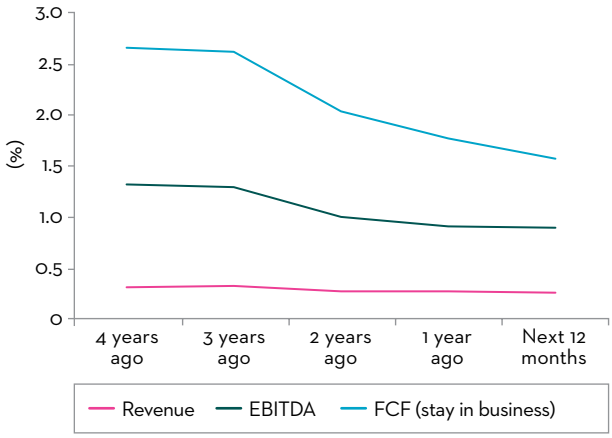
As discussed earlier, for strong businesses with the pricing power to pass through costs to customers, higher inflation can be an income growth opportunity for equity investors rather than a challenge. Inflation can lead to increased company revenues which ultimately contributes to higher company dividends. This critically is not a feature of fixed income.

Furthermore, the strength of Australian company balance sheets, low debt and current low level of payout ratios means that there is only room to improve.

Pay out ratio



Net debt ratios



Reporting season has shown us that overall expectation for earnings and dividend growth is modest for the Australian market due to the fact that we have already seen a significant rebound in earnings over the past year, and slower growth expectations for resources going forward. Despite a tempered income growth outlook for the overall market, we have solid expectations in the high-quality Financials, Real Assets, Industrials and Resource stocks that we invest in our Income strategies. Relative to the broader equity market, the forecast yield premium for the MCA Equity Income strategy remains near a record high and looking forward, we expect income growth to come from a combination of COVID-recovery stocks and COVID-winners.

On a forward-looking basis, the strategy is expected to provide a franked dividend yield of 7.0% over the next 12 months, with forward income growth exceeding the latest inflation peak. This compares very attractively to the 5.4% expected franked yield for the S&P/ASX 200.

The MCA Equity Income strategy is designed to provide a solution to uncertainty, offering exposure to a diversified portfolio of high-quality securities that pay higher income, provide inflation protection, and have lower volatility than the broader share market.

Sources and disclaimers for this section

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Portfolio data calculated for the representative Martin Currie Australia Value Equity and Equity Income account.

Franked yields assume zero percent tax rate and full franking benefits realised in tax return.

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- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- The Value Equity strategy may invest in derivatives (index futures) to obtain, increase or reduce exposure to underlying assets. The use of derivatives may restrict potential gains and may result in greater fluctuations of returns for the portfolio. Certain types of derivatives may become difficult to purchase or sell in such market conditions.
- Income strategy charges are deducted from capital. Because of this, the level of income may be higher but the growth potential of the capital value of the investment may be reduced.

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