Equity Trustees

March 2024

ASSET CLASS INSIGHTS

AUSTRALIAN EQUITIES REPORTING SEASON REVIEW

Key points:

- The results delivered in reporting season were reasonable relative to expectations, due to a combination of resilient economic data, cost management and low analyst expectations.
- Despite solid results, future earnings growth forecasts were marginally revised down.

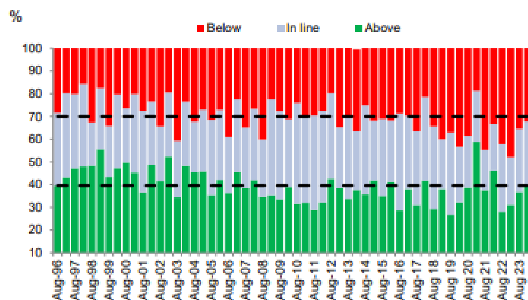
THE EARNINGS WASH UP

Overall, relative to expectations, there were more earnings-per-share (EPS) beats than misses during the February reporting season. The ratio of beats to misses was broadly in-line with historic levels. Despite rising interest costs, corporate balance sheets are relatively healthy. Dividends were also better than expected due to strong payouts from banks and miners. Large caps produced better outcomes than small caps.

There were less revenue beats than earnings beats. Revenue growth averaged 6% in the half with inflation (CPI of 4.7%) contributing most to the gains. Inflation and price increases have continued with a resilient consumer somewhat still weathering higher prices as companies pass through cost increases. Price increases were noticeable in insurance, building materials and mobile pricing. Healthcare pricing in general lagged CPI due to government controls.

40% OF ASX200 FIRMS BEAT CONSENSUS

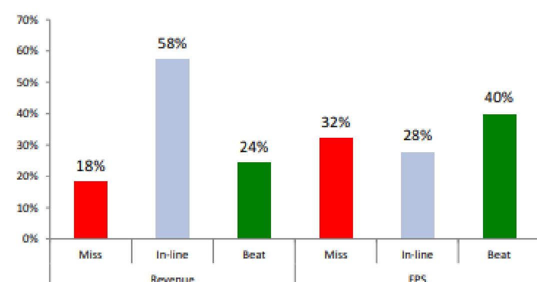
% of companies beating/in-line/missing EPS consensus



Source: Goldman Sachs Global Investment Research, Bloomberg

COST CONTROLS DROVE POSITIVE EPS SURPRISES

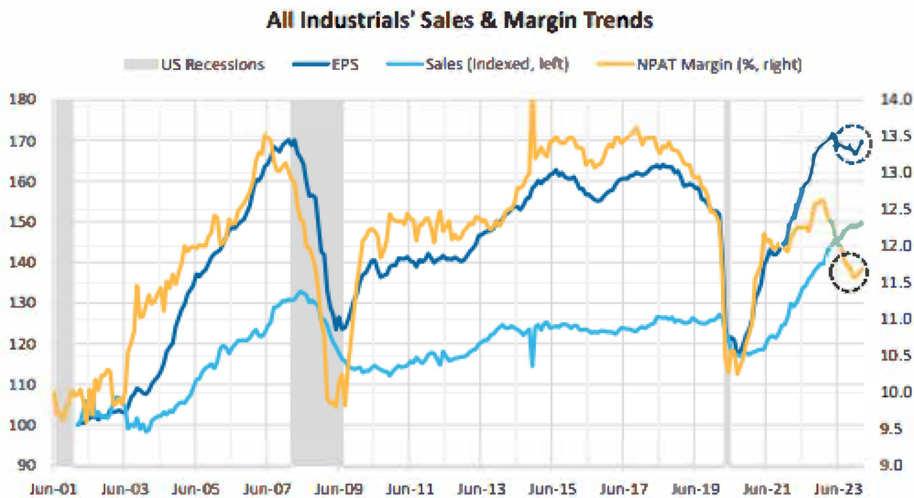
% of companies beating/in-line/missing Revenue and EPS consensus



Source: Goldman Sachs Global Investment Research, Bloomberg

Margins held up better than expected due to strong cost management which was a notable feature over reporting season. Management have worked hard to offset the impact of rising labour and material costs. Interestingly, headcount reduction was not a major reason for cost out. However, margins have been softening, and companies face higher interest costs, sticky wage inflation as well as rising capital expenditure (capex) bills. According to Goldman Sachs, capex spending (in nominal terms) has now passed the peak of 2012's commodity led investment cycle. Higher capex bills have lessened the number of buybacks being undertaken.

MARGINS HELD UP BETTER THAN EXPECTED BUT HAVE BEEN SOFTENING



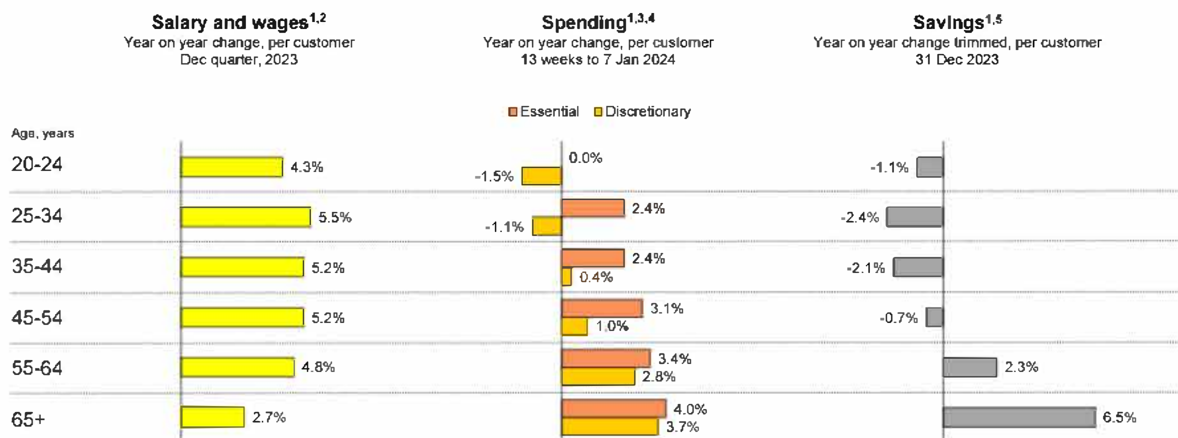
Source: FactSet, Macquarie Research, March 2024.

Despite fears about the impact of rising mortgage costs on overall consumption and economic growth, the domestic environment remained quite resilient up to the end of December 2023. A combination of strong labour markets, strong immigration, accumulated Covid related savings and higher house prices have preserved consumer spending. This served the consumer discretionary sector well with retailers reporting better-than-expected results and banks reporting low bad debts.

However, digging deeper there is a large divergence in the consumer landscape. As the chart below (sourced from Commonwealth Bank's half year presentation pack) shows, younger demographics are feeling the pinch of higher interest rates, lower real incomes, and lower savings. On the flipside, the older generation have been more supported by the swelling pool, and associated benefits paid, of retirement savings, higher rates on term deposits and higher house prices.

Higher rates unevenly felt

Many households cutting back to adjust to higher cost of living



1. Consistently active card customers and CBA brand products only. 2. Paid into CBA transaction accounts, represents customers with payments identified as salary and wages after PAYG but before net tax return, excludes government benefits, excludes gig economy. 3. Spending based on consumer debit and credit card transactions data (excluding StepPay). 4. Essential includes communication, education, food goods, household services, insurance and other financial, medical and health, transport, and utilities. Discretionary includes alcohol, clothing and footwear, food services, general retail, household furnishings and equipment, personal care, recreation, and other miscellaneous goods and services. 5. Average savings balances for MFI customers. Includes all forms of deposit accounts (transaction, savings and term), home loan offset and redraw balances. Trimmed mean excluding top and bottom 5% of customers within each age band.

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SECTOR AND STOCK HIGHLIGHTS

Over the course of the month the best performing sectors were Information Technology (+19.5%), Consumer Discretionary (+9.1%) and Property (+5.1%). Key drivers for outperformance included:

- Information Technology (IT) – Future earnings were slightly upgraded during the month, mainly driven by Wisetech (WTC) (+4%) and Megaport (MP1) (+23%). Altium received a takeover offer during the month despite a result below expectations. Demand for hardware and software supporting Artificial Intelligence (AI) solutions has further improved the outlook for companies like NextDC (NXT) and Megaport (MP1). Wisetech (WTC) continues to benefit from their market leading products in logistics with recent acquisitions buoying the outlook.
- Consumer discretionary – despite a bifurcated consumer and macro headwinds, stocks produced better than expected results, albeit expectations were low. The consumer has remained more resilient than many expected twelve months ago. Future forecast earnings were upgraded as analysts looked to upcoming tax cuts and lower interest rates to cushion spending patterns. Notably, companies with good value propositions took share while improved supply chain management helped. JB Hifi (JBH), Temple & Webster (TPW), Nick Scali (NCK), Wesfarmers (WES), and Lovisa (LOV) all delivered stronger than expected results. These, better than expected results were more due to self help on costs than any improvement in the underlying markets.
- Property – the property sector outperformance was fuelled by Goodman Group (GMG) which is the largest stock in the sector. GMG rallied 16.8% following a strong result and consensus earnings upgrades of 2%. GMG was also noted for inclusion in the Global Real Estate Index which further added impetus to the stock price.
- Banks – The banks reported better than expected results with earnings forecasts marginally upgraded (on average around 1%) on better asset quality (lower bad debts) and better revenue generation in markets and treasury divisions. These factors offset net interest margin pressures. The banks sector continued its recent rally despite the outlook for negative earnings growth in FY24 and FY25 and elevated valuations. CBA remains one of the most expensive banks in the world and became more expensive during the month.
- Developers and Contractors (D&C) – The D&C sector reported strong results and benefited from supportive private capex programs, continued government spending as well as strong pricing and cost discipline.

Sectors that underperformed included Energy (-5.9%), Materials (-5.0%) and Healthcare (-2.7%). Earnings misses were more common across Healthcare and Energy & Resources. Key factors impacting these sectors were:

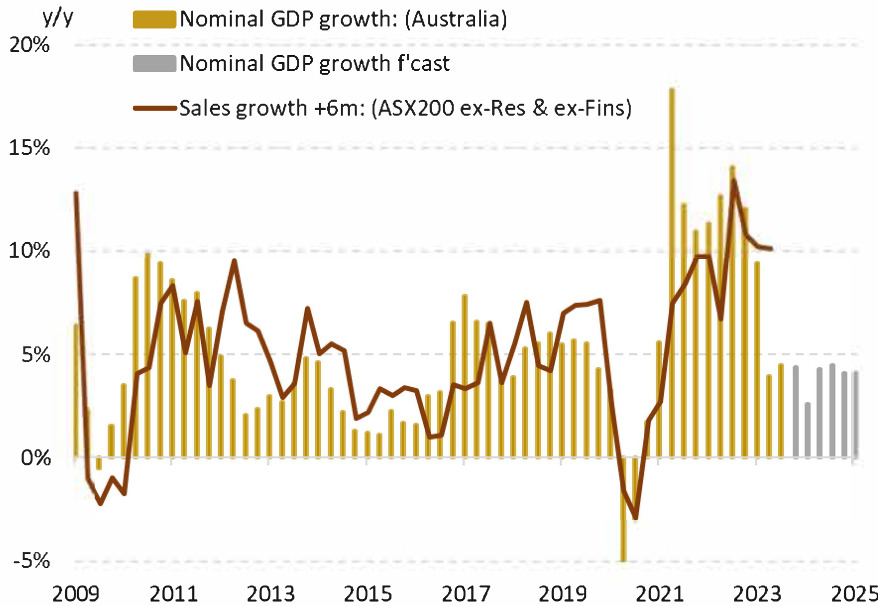
- The Energy and Resources sectors have been affected by lower commodity prices. Whilst earnings met expectations the outlook was downgraded due to the uncertainty around the health of the Chinese economy and cost inflation.
- The Healthcare sector continued to be plagued by cost issues. In particular, Helius (HLS) and Sonic Healthcare (SHL) were punished as cost increases were not able to be passed on to end users due to government regulation around product pricing.

Stock price volatility during February was higher than normal with 15% of stocks moving +/-10% and nearly 30% moving +/-5% on the day of their result. Volatility in moves during reporting season has continued to increase over the last decade allowing nimble, active managers to pounce on stock picking opportunities.

THE OUTLOOK

Despite results beating expectations, outlook statements were more balanced, and earnings forecasts were marginally revised down. Perversely, cooling inflation may be a negative as it will start to slow top line nominal growth for many companies. Inflation and price rises, which consumers have accepted, have been a key ingredient to stronger than expected earnings over recent times.

NOMINAL GDP GROWTH VS SALES GROWTH

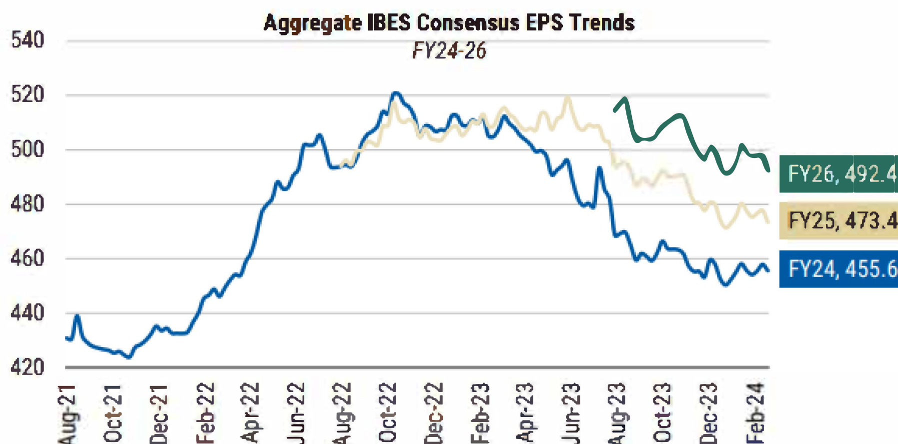


Source: UBS, Refinitiv

IT and consumer discretionary sectors registered earnings upgrades, however that was offset by downgrades in Communication Services (Media and telecommunications) and Materials.

FY24 ASX200 earnings growth appears to have plateaued at -5.5%. As the chart below shows, after seeing continued earnings downgrades in 2023, earnings revisions have been more balanced over recent months. Earnings in FY25 are expected to rebound ~3.9% but have been slightly downgraded from before reporting season when the market was expecting growth closer to 4.5%.

ANNUAL CONSENSUS AGGREGATE EARNINGS LEVELS TRENDS



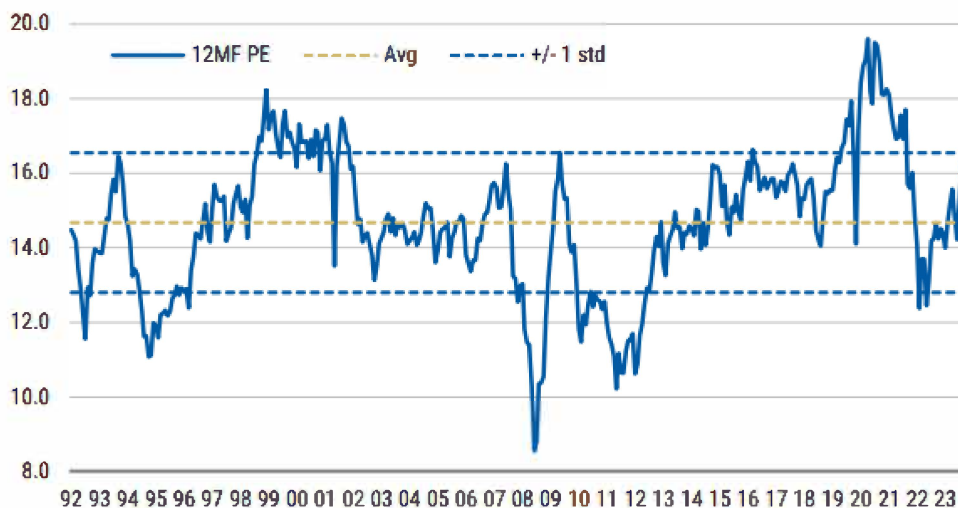
Source: RIMES, IBES, Morgan Stanley Research.

While there remains some risk to near term earnings, the stabilisation in earnings revisions and the recent reporting season quality is likely to see investors look through FY24 estimates and focus on the outlook for FY25 and beyond.

Reported dividends broadly met expectations and forecast dividends were only marginally adjusted. According to Citigroup market dividends are expected to fall 1.9% in FY24 before rebounding slightly in FY25 by 0.5%.

Given the market rose over February and future earnings were downgraded, the Price-earnings (PE) multiple of the ASX200 expanded to 16.4x and resides above the long-term average (of 14.7x). Much of this re-rate was experienced in IT, Building Materials, Banks, Insurance and Consumer Discretionary which may indicate that investors are expecting interest rate falls to support the economy and keep domestic demand resilient. Further, the increase in capital market activity and M&A has also served to support market multiples.

ASX200 PRICE-EARNINGS (PE) RATIO



Source: RIMES, IBES, Morgan Stanley Research.

Following a strong rally, we think the market is due to take a "breather" given slowing economic growth, slightly expensive valuations, and a re-appraisal of the magnitude of US rate cuts. However, a rebound in (FY25) earnings growth coupled with potential interest rate cuts later in the year should support the equity market heading into 2025.

EQT AUSTRALIAN EQUITY FUND PERFORMANCE

The EQT Flagship, Tax-Aware and Responsible Investment Australian Share Funds outperformed the ASX200 Accumulation index by 15bps, 21bps and 24bps respectively in February. During the month, our analysts attending a range of management briefings and results presentations to better understand the key drivers of the company results, the present operating conditions and assess management ability.

The funds benefited from a range of active positions, however the key drivers of outperformance included underweight positions in Fortescue Ltd (FMG), Woodside Energy (WDS), BHP Group (BHP) and Woolworths (WOW) as well as an overweight position in Pilbara Minerals (PLS). Conversely, detractors to performance included underweight positions in Wesfarmers (WES) and Wisetech Global (WTC) as well as overweight positions in Nine Entertainment holding (NEC), South32 (S32) and ResMed (RMD).

PROCESS IN ACTION – GOODMAN GROUP (GMG)

One of the most notable results during February was that of Goodman Group (GMG). Equity Trustees currently holds Goodman Group (GMG) in our Australian equity portfolios. The stock has been a strong contributor to portfolio gains over the last year.

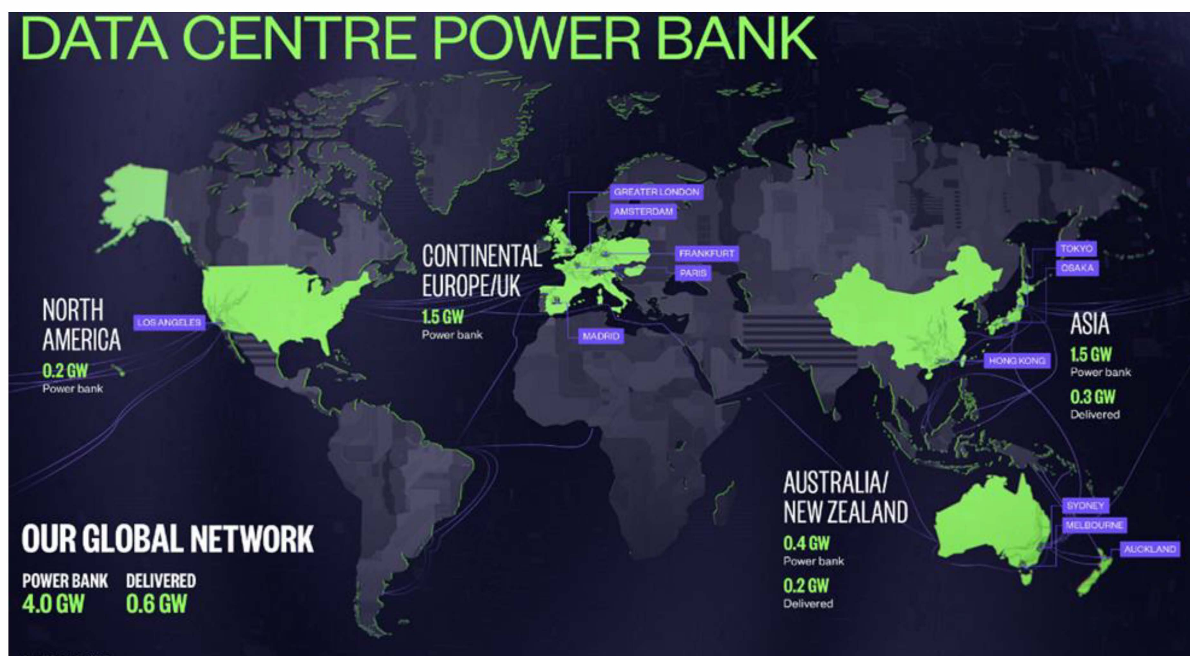
GMG is an owner, developer and manager of industrial property globally with key market exposures in Australia, Europe, US and Asia. The company offers strong earnings growth through its exposure to Metro Industrial and Data Centre assets. They have a large development pipeline, sizeable funds management business and is well managed.

We are attracted to GMG's strong fundamentals and appealing earnings outlook. GMG operates in high barrier to entry markets that continue to deliver strong results. GMG's focus is on tightly held infill markets where demand is greater than supply. The scarcity of space in GMG's key markets, the complexity of planning and the increased construction time and cost is driving a significant increase in replacement costs. This has fed into strong rental growth and in turn is supporting strong underlying property fundamentals across their existing assets and development book. The data centre opportunity only adds to the strong earnings outlook and earnings visibility for the business.

The company delivered a very strong result in February beating consensus earnings forecasts by 13% and upgrading FY24 guidance. The Balance sheet gearing remains sound.

Fundamentals in GMG's core gateway industrial markets remains strong. Occupancy in their industrial assets remains high and income growth robust. GMG maintains strong locations in major cities across the globe putting them in an enviable position. E-Commerce trends and supply chain / last mile reform are drivers of growth. Strong re-leasing spreads and record low vacancies have led to strong rental growth, supporting asset values which has offset rising cap rates.

The Data Centre opportunity continues to increase. Data Centres now represents 37% of Work-in-Progress (WIP) within the Development division. Yield on completion is attractive and growing, and margins are higher than those achieved in the core Industrial business. GMG will be reviewing further sites for potential Data Centre use given the insatiable demand on the back of the AI boom. The company stated it has 4.0GW 'identified power bank' up from 3.7GW. GMG's confidence in the opportunity was demonstrated by shortening the delivery time of the target opportunity (~$50-60bn) from ten years to five-seven years. Much of this work will be developed on balance sheet offering upside to development earnings.



Should this opportunity transpire the operating earnings per share growth over the next three years will be 11% per annum. Further with bond yields near their peak, valuation headwinds will lessen for the group. Inclusion into the FTSE EPRA NAREIT (Global Rea Estate) index in the near term should also lead to more offshore investors evaluating the company and passive flow supporting the stock.

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