Entrust

Reporting Season Update

August 2023

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FY23 Reporting Season

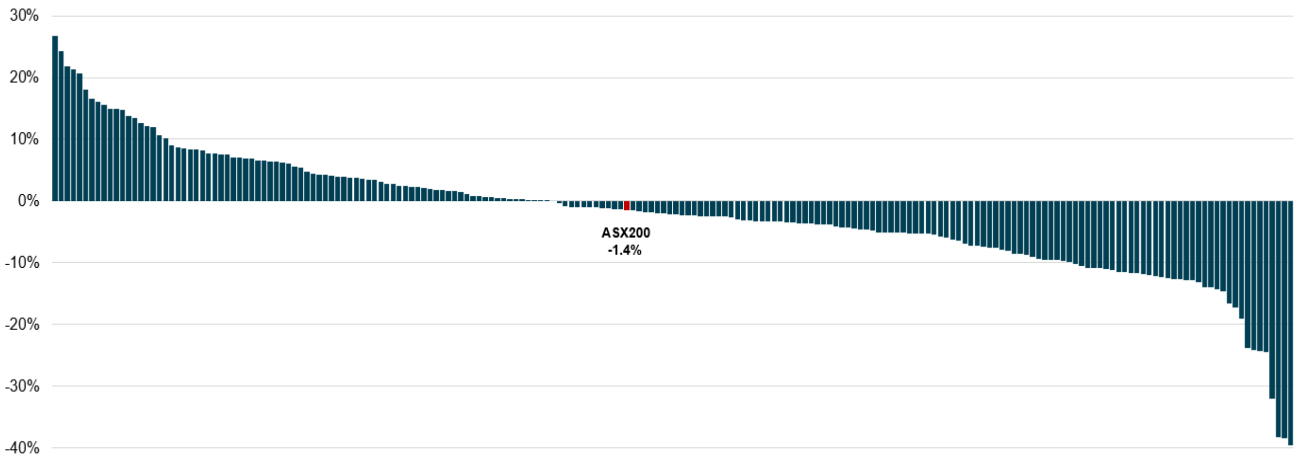
During August 2023 the ASX200 index declined by 1.4%, while the ASX200 Accumulation Index (including dividends) was down by 0.7%. The average individual stock return (excluding dividends) was negative 1.8%.

As always, the dispersion of individual stock returns in the month of results season was wide, the best performing stock was Altium Limited ASX:ALU) a technology company involved in the design of printed circuit boards, which was up 27%, while at the other end of the ladder was IRESS Limited (IRE) a provider of software to the financial services industry which was down 38%.

In terms of stock-by-stock performance, 54% of individual stocks underperformed the ASX200, while 46% outperformed (Figure 1).

Relative to market expectations, results were evenly spread between Good, Bad and OK (Figure 2).

Figure 1: ASX200 – Individual Stock Performance in August



Source: Iress

Note: Returns are based on change in share price only and do not take into consideration dividends.

Figure 2: FY23 Reporting Season – ASX200 Results versus Expectations

Beats	In Line	Misses
49	56	53
31.0%	35.4%	33.5%

Source: FNArena

Key Themes & Features: What companies are saying

We discuss some of the key themes that we saw coming out of reporting season, below:

Consumers are slowing down, but resilient

While the consumer slowdown has certainly commenced, the resilience of consumers has undoubtedly surprised to the upside during FY23, with many retail companies reporting results well in excess of market expectations 12 months ago.

A number of retailers noted that in this tougher environment consumers are, understandably, seeking out better value. We think that this sees companies such Wesfarmers (WES) (the owner of Bunnings, Kmart & Target) and JB Hi-Fi (JBH) well positioned, certainly relative to those more discretionary retailers with much smaller networks.

Theft becoming a bigger issue

Theft, or "shrinkage" to use the more politically correct term adopted by retailers, has risen markedly in recent times, both in the US and here. Target in the US expects theft related losses to be around US$1.3bn, up from ~US$0.8bn last year, while both Woolworths & Coles called out a noticeable increase in theft impacting their bottom lines.

Companies well prepared

The widely held expectation that both the domestic and global economies will slow, has been front of mind for many for quite some time.

This appears to have provided many companies with ample opportunity to prepare for the expected tougher times through, for example, reducing their cost bases where possible and looking to shore up balance sheets.

Borrowers well prepared

Commonwealth Bank (CBA) reported its FY23 result in August while the other major banks provided brief updates. While we are now in the midst of the much-vaunted "fixed rate cliff" whereby borrowers are rolling off low fixed interest rates to higher prevailing variable rates, the Banks are reporting that while arrears have increased, they remain at historically low levels.

CBA noted that to date, those borrowers rolling off from fixed rate loans are showing arrears no greater than existing variable rate customers.

These looming "roll-offs" have been known for quite some time; and whilst many companies have prepared in advance for tougher times, it seems borrowers as a whole have been preparing for increasing interest rates and the impacts this has on family balance sheets.

Easing in bank mortgage competition

Numerous offers to entice home loan borrowers were available in the earlier part of 2023. These offers have gradually been withdrawn from the market, with a number of Banks noting that competition has eased, from the intense levels seen previously. CBA, National Australia Bank (NAB) and Bendigo Bank (BEN) all noted that they had pulled back their Home Loan lending due to uneconomic loans being written. While this reduction in competitive intensity is bad for borrowers, it is good for shareholders.

Healthcare margins under pressure

Sector wide margins in a number of healthcare names (e.g., CSL, ResMed, Ramsay) have continued to be under pressure, certainly for longer than expected as a result of a variety of factors, including supply chain issues and access to labour.

Logistics & Industrial properties seeing huge rent increases

With occupancy levels above 99% and continued strengthening in demand, logistics / industrial properties are seeing and are expecting to see large rental increases. Goodman Group (GMG) notes that rents achievable for new leases are running at an average of 37% above current rents, consistent with GPT Group (GPT) noting that leasing spreads (new rent v prior rent) are running at increases of ~40%.

Cost inflation feeding through

Many businesses, large and small, listed and unlisted, are confronting an increased cost of doing business.

Key areas relate to wages (minimum wage increase of 5.75% from 1 July 2023), rising rental costs (with many properties having CPI-linked increases) and increased energy costs.

Higher interest costs

While this shouldn't be a shock given widespread awareness that interest rates have been increasing, the impact of increased interest costs on some companies has been higher than market expectations.

Portfolio & Watch List Holdings

Below we provide brief commentary on some companies held within the portfolio along with additional commentary on other companies that sit on our "Watch List", being those companies we continue to closely monitor for possible portfolio inclusion.

BHP Group Limited ASX: BHP

Underlying Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) of US$28bn, down 31%.

- Full year dividend of US$1.70 per share, including a final dividend of US$0.80 per share.
- Balance sheet remains strong, notwithstanding an increase in net debt to US$11.2bn, of which US$7.0bn was related to the acquisition of OZ Minerals. Gearing stands at 19%.
- For the 13th year out of the last 14 years, since 2010, BHP delivered greater than US$15bn in net operating cash flow, again highlighting the cash generative qualities of the BHP asset base.
- Looking forward BHP sees that the lag effect of interest rate increases will suppress economic growth in the developed world, while demand in India is expected to remain robust. In regard to demand from China, BHP expects it to be relatively robust, however the extent to which, is reliant on how effective Chinese stimulatory policy moves will prove to be.
- On the cost side, BHP highlights that the tight labour market and likely inflationary wage costs is expected to impact on their cost base.
- BHP expects to increase annual capital expenditures in the years ahead to ~US$10bn, with the growth focus being on "future-facing" commodities, including ongoing investments into copper, nickel and potash.
- As always, BHP's earnings will be heavily reliant on commodity prices, however with Tier 1 assets and its solid balance sheet, we see BHP as well placed into the future.

Commonwealth Bank ASX: CBA

Cash Net Profit After Tax (NPAT) of $10.2bn, up 6% on FY22.

- A final dividend of $2.40 per share was declared, bringing the full year dividend to $4.50, which we note is not too far below the $5.40 per share at which CBA shares were floated in 1991.
- On a full year basis this equates to a fully franked dividend yield of 4.4%.
- CBA also announced further capital management initiatives via a $1bn market on-market buyback to be undertaken during FY24.
- CBA's balance sheet remains strong, carrying capital of ~$9bn in excess of APRA's regulatory requirement.
- CBA noted that home loan arrears, while expected to increase, remain at historically low levels.
- While expecting a moderation in economic growth and a slowing in consumer demand, CBA highlights the strong fundamentals of the Australian economy, including low unemployment, strong exports and high levels of immigration.

CSL Limited ASX: CSL

Net Profit After Tax (NPAT) of US$2.6bn, slightly above the top end of guidance.

- CSL announced a final dividend of US$1.29 per share.
- Underpinned by a positive outlook across CSL's three core divisions, management is confident around continued growth into FY24, with NPAT guidance of US$2.9-3.0bn.
- Management continues to be focussed on driving continued gross margin improvement in the key CSL Behring business.
- Vifor, which CSL acquired in August 2022 for ~US$12bn provided an initial ~11month contribution. Management remains very pleased with how the business has gone to date and with the growth opportunities that remain. To date we see the performance of Vifor as pleasing, given the potential issues that can arise with large acquisitions.

GPT Group ASX: GPT

Occupancy across GPT's asset portfolio was 97.9%, with Logistics being very strong (99.8%), Retail resilient (99.5%) and unsurprisingly Office remains challenging (88.5%).

- Net Tangible Assets (NTA) reduced by ~2% from $5.98 to $5.85 per share as property valuations decreased due to the impact of rising interest rates partially offset by increasing rents received.
- There are general concerns in the market around property valuations, particularly for Office assets. In this regard, we note that GPT's share price currently trades at a discount of ~28% to its NTA, suggesting that the share price contains a material margin of safety and provides reasonable upside potential.
- GPT's balance sheet remains in good shape and the business confirmed guidance for a full year distribution of 25.0 cents per unit, implying an unfranked dividend yield of 6.0%.

Pilbara Minerals Ltd ASX: PLS

Net Profit After Tax (NPAT) of $2.3bn up over 300% on FY22.

- This very strong result was driven by a combination of increased production to 620,000 tonnes (up 64%) and increased realised spodumene prices (up 87%).
- A final dividend of $0.14 per share was declared, bringing the full year dividend to $0.25 per share.
- PLS ended FY23 with Net Cash of $3.1bn.
- PLS expects to produce between 660,000 – 690,000 tonnes of spodumene concentrate in FY24, as the business continues to develop its expansion plans to ~1,000,000 tonnes per annum.
- While we expect continued volatility in lithium prices, given that PLS is in production and generating significant cashflow, we think that the business remains well-placed.

REA Group ASX: REA

Net Profit After Tax (NPAT) of $372m, down 9%.

- Final dividend of $0.83 per share, bringing the Full year dividend to $1.58 per share.
- Across FY23 new Buy listings, a key driver of REA's revenue, were down 12% due to the subdued Australian property market.
- Offsetting this decline in listings, the strength of REA's business franchise was again exhibited as the business drove average Buy yield growth (i.e., average growth per Buy listing) of 12% on the back of price increases and deeper penetration of higher priced products.
- Losses from REA India grew as the business continued to invest as it seeks to widen its market leadership position.
- Heading into FY24, REA expects lower losses from India. While the core Australian business will ultimately be driven by the level of Buy listings, the business expects to put through an average national price rise of 13%.
- We have recently sold portfolio holdings in REA Group. With the share price having increased by nearly 70% since June 2022, we believed that the price was factoring in a very rosy outlook.
- We would be keen to repurchase REA in the future, if and when the share price opportunity presents.

ResMed Inc. ASX: RMD

Net Profit After Tax (NPAT) US$950m, up 12%.

- 4th quarter dividend of US$0.048 per share, bringing full year dividends to USD$0.18 per share.
- RMD reports its results quarterly as it is listed on the New York Stock Exchange. It's 4th quarter results showed slightly weaker margins than were expected on the back of a number of issues (product mix, supply chain / logistics costs).
- These margin impacts look short-term in nature, as such we believe there is a high probability margin recovery will be seen over coming periods.
- Over the course of the last month RMD's share price has been under heavy pressure, which stems largely from recent news around an obesity drug called Wegovy, manufactured by Danish pharmaceutical company Novo Nordisk. Initial results from an in-house study conducted by Novo Nordisk shows that Wegovy may help in reducing major adverse cardiac events (e.g., heart attacks) by around 20%. More details around the study results are expected to be released in November this year.

- It is very early days in regard to understanding what, if any, impact Wegovy (should it prove to be successful) may have on demand for RMD's products and services. We think there has been a material element of "shoot first, ask questions later" in regard to the reaction seen in RMD's share price.
- We will continue to monitor the situation; though at this stage we think that RMD remains well-placed, given it is the global leader in an industry that displays strong long-term thematics.

Santos Ltd ASX: STO

STO reported 1st half 2023 Underlying NPAT of US$801m, down 37% from US$1,267m as a result of lower average oil prices.

- Free cash flow from operations of US$1,129m was generated, down 34% from US$1,708m.
- An interim dividend of US8.7 cents per share was declared.
- Subsequent to its result, STO announced the selldown of a 2.6% stake in PNG LNG to Kumul Petroleum (PNG's national petroleum and energy company) for total consideration of ~US$735m. In addition, STO notes that Kumul has an option to acquire a further 2.4% for total consideration of ~US$670m, with the option exercisable on or before 30 June 2024.
- Another key driver in the short-term for STO will be the decision from the environmental and regulatory agency (NOPSEMA) as to whether or not STO can recommence drilling as part of the construction of its Barossa project off Darwin.

Wesfarmers Limited ASX: WES

Net Profit After Tax (NPAT) of $2.5bn, up 5%.

- Full year dividend of $1.91 per share, including a final dividend of $1.03 per share.
- On a full year basis this equates to a fully franked dividend yield of 3.5%.
- This was a strong result from WES. In particular the result provided evidence that WES key retail businesses, including Bunnings, Kmart, Target and Officeworks have performed well as their strong value credentials resonate with consumers. Management also remained confident in regards to the outlook for these businesses, particularly Kmart.
- The other highlight to come from the result was confirmation that Covalent, the lithium business in which WES is a 50/50 JV partner with major lithium producer SQM, expects to deliver first revenues and profits in 2H24.
- Since the release of its result, WES share price, inclusive of the final dividend, is up over 10%, potentially suggesting that the market may finally be starting to recognise some of the value within the lithium business, which, we believe, has to date been largely ignored.

Watch List Companies

Goodman Group ASX: GMG

Operating profit of $1.8bn, up 17% on FY22.

- Operating earnings per share of 94.3 cents per share, with growth of 9% to 102.9 cents per share forecast for FY24.
- Full year dividend of $0.30 per share. FY24 dividend to be maintained at $0.30 per share, which takes into account GMG's current levels of development activity combined with its desire to keep gearing at the lower end of their target range of 0-25%.
- Balance sheet remains in excellent shape with gearing at 8.3% and look-through gearing (which includes GMG's share of debt held in co-investments) of 20.8%.
- GMG reported very strong portfolio occupancy of 99% as demand for industrial / logistics assets remains robust.
- Despite the macro uncertainty, GMG notes that its structural drivers remain sound, driven by the digital economy, the need for more efficient and sustainable assets, and limited supply in our markets.

JB Hi-Fi Limited ASX: JBH

Net Profit After Tax (NPAT) of $525m, down 4%.

- Final dividend of $1.15 per share, bringing the Full year dividend to $3.12 per share.
- JBH delivered another strong result, which was nearly 30% higher than analysts had been expecting at the start of FY23, serving to underline both the quality of the business and the ongoing resilience of the Australian consumer.
- JBH's balance sheet remains in excellent position with net cash of $127m.
- Into FY24, JBH expects consumers to continue to be on the lookout for value. Given the market positioning of both JBH and The Good Guys (TGG) as providers of a strong value proposition JBH is reasonably well placed.
- JBH also noted cost pressure challenges will be seen in FY24 on the back of mandated 5.75% minimum wage increases, increased rental expenses and increased energy costs

Telstra Group Ltd ASX: TSL

Net Profit After Tax (NPAT) of $2.1bn, up 13%.

- Underlying Earnings Before Interest Tax Depreciation & Amortisation (EBITDA) of $8.0bn, up 10%
- Final dividend of 8.5 per share bringing the full year dividend to 17.0 per share
- On a full year basis this equates to a fully franked dividend yield of 4.2%.
- Strong growth in the Mobiles business, which contributed nearly 60% of group earnings, offset weakness in some other areas.
- TLS also announced that it would maintain 100% ownership of its Infrastructure assets (InfraCo) for at least the medium term. This somewhat disappointed investors as the expectation had been that the assets were to be monetised in some way in the shorter-term.
- TLS provided guidance for FY24 EBITDA of $8.2-8.4bn and confirmed that the financial targets for its "T25" strategy remain on track.

Woolworths Group Ltd ASX: WOW

Underlying Net Profit After Tax (NPAT) of $1.7bn up 14%.

- Final dividend of $0.58 per share, bringing the full year dividend to $1.04 per share
- WOW's core Australian Food division delivered a very strong result with EBIT up 19% (or 9.5% when adjusting for COVID costs incurred in FY22).
- Big W experienced tough conditions, particularly in 2H23 as consumers cut back on discretionary expenditure.
- Looking to FY24 WOW noted that cost pressures will impact, driven by the 5.75% increase in the minimum wage, 0.5% increase in superannuation, the Victorian payroll tax, along with ongoing cost inflation from energy and transport costs.

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