Entrust

Reporting Season Update – February 2023

Inflation and Interest Rates Making Their Presence Felt

In the six months since the August 2022 results season, the RBA Cash Rate has increased a further 1.00%, moving from 2.35% to 3.35%. Expectations around the peak level of interest rates in this current cycle have also increased, with the Big 4 banks now expecting the rate to peak at between 3.85% - 4.10%. Coupled with this, inflation remains high (up 7.4% in the year to the end of January) as the economy deals with increasing prices associated with labour (i.e., wages), energy and supply chains.

In regard to how major Australian companies are handling these challenges, the Australian Financial Review (27 February 2023) summed it up well; *"If there's one big takeaway (from reporting season), it's this: the slowdown in the Australian economy is still to come. The vast majority of Australia's biggest companies have managed to pass through higher costs with little problem, their balance sheets are generally very strong and their outlooks are cautiously optimistic. A squeeze on margins as demand falls faster than costs might be coming, but it ain't here yet."*

At a sector level, some of the key themes that caught our attention include:

Banks

The Commonwealth Bank (***CBA***) reported a solid result with cash profit up 9%. The other major banks (***NAB, WBC, ANZ***) provided brief updates as they have an end of March reporting period. In summary:

- Lending books are in good shape across the board with home loans 90-days in arrears at very low levels (at around 0.6% of total loans outstanding). While some "pain" for borrowers can be expected, the pool of loans that the Banks are concerned about are very small in the overall scheme of things.
- The fundamentals of the Australian economy remain solid – low unemployment, strong exports and returning migration.
- Mortgage competition is high – with less loans being written banks are competing aggressively to win and retain home loan customers.

Residential Housing

A favourite headline grabber for media outlets. A number of property developers (Cedar Woods, Peet, Mirvac and Stockland) have unsurprisingly reported a softening in conditions coupled with ongoing issues in delivering developments due to impacts around supply chains, labour availability and wet weather on the East Coast. The sector is experiencing a number of headwinds at present which will see activity slow. The positive side of this impending slowdown is that the various constraints described above should resolve over time. The slowdown in activity has started, evidenced by:

- Realestate.com (***REA***) reported that the number of residential listings on its website were down 21% in the December quarter. Separately, we highlight that ***REA*** implemented 6% price rises during the period; showing the pricing power benefits of being in an oligopoly / near monopoly.
- Mortgage broking business Australian Finance Group (***AFG***), which is involved in 1 in every 10 home loans written in Australia, reported loan lodgements down 18% in the December quarter.
- The Australian Prudential Regulation Authority (***APRA***) sets macroprudential policy in Australia. Among APRA's settings is a 3% serviceability buffer, requiring lending institutions to apply a 3% increase to a borrower's interest rate for the purpose of calculating the maximum amount that can be borrowed; for example, if the standard home loan rate was 5.50%, the lender has to calculate a borrower's ability to service repayments based on a rate of 8.50%. APRA has recently

confirmed that this buffer remains appropriate. This policy is in place to ensure prudent lending is conducted, whilst also having the effect of reducing the amount that a borrower can borrow.

Notwithstanding the above short-term impacts (remember this is a cyclical part of the economy) most industry participants cite the solid long-term outlook based on a supply / demand imbalance, the tight rental market and the return of inbound migration.

Commercial Property (REITs)

In our September 2022 quarterly review, we discussed the relative attractiveness of the ASX-listed Real Estate Investment Trust (A-REIT) space on the back of the significant share price declines the sector had experienced. In general, what we have seen in the ensuing five-month period is that to date, things have not been as bad as share prices had been suggesting, with the A-REIT index gaining ~20% since the end of September 2022. During the reporting period, we saw:

- Capitalisation rates (one of the key inputs used in valuing property assets) start to increase, resulting in some downward revisions to Net Tangible Asset (NTA) values.
- Interest costs increasing on the back of interest rate rises. This is a key cost for most A-REITs and will impact on the level of distributions available to be paid out to shareholders.
- The above negative impacts were offset to varying degrees by strong growth in rental income, particularly for those assets that have CPI-linked contracted rental increases.

Portfolio Action*:** In late 2022, where appropriate, we added GPT Group (GPT***) to portfolios and in recent weeks have selectively topped up this exposure on the back of the solid yield (~5.5%) that GPT offers, while trading at a relatively large (~20%) discount to NTA.

Retail

The retail sector has proven remarkably resilient for (much) longer than most had been expecting. This result season saw very strong results for retailers such as JB Hi-Fi (***JBH***) and Nick Scali (***NCK***). However, finally it looks like there may be some slow down coming through as a result of interest rate rises, with sales growth in the December quarter and into early 2023 showing some signs of weakening; albeit from a very high base and at levels that remain well above those seen pre-COVID.

We heard interesting commentary from Wesfarmers and JB Hi-Fi management teams, both of whom we rate highly, in that they had the opportunity to generate higher profits during the period through flexing their pricing power. However, both businesses chose not to exercise this power, with their long-term focus toward ensuring that their reputations for price leadership remain embedded in customers consciousness.

Potential Opportunities*:** We continue to monitor quality retailers such as ***JBH and ***NCK*** closely. These businesses have been very well-managed over many years, have strong balance sheets and generate excellent cash flow. As we enter a tougher period for retailers, we expect that earnings will likely decline from the exceptionally strong results generated in the post-Covid period. On the back of these cyclical earnings downturns, if history is a guide, we think there is a reasonable likelihood that equity markets will sell down these quality businesses to prices that provide attractive long-term entry points. Of course, buying stocks at times when sentiment to particular businesses or sectors is negative can prove to be psychologically difficult, however it is often these "uncomfortable" purchases that can ultimately provide strong long-term returns.

Non-Discretionary Retail

Both Woolworths (***WOW***) and Coles (***COL***) reported that food inflation in the December quarter ran at 7.7%. Customer behaviours were changing somewhat - ***COL*** identified a *"tale of two cities"* as premium customers kept spending while value hunters pulled back or traded down to cheaper items. In a recurring theme, both retailers noted material cost inflation on the back of higher labour, energy and supply chain costs.

Market Performance

While we caution against paying too much attention to short-term market gyrations, the performance of markets on the back of result season can display heightened volatility based on the results and outlook statements, both individually and collectively, provided by businesses. During February the benchmark ASX200 Accumulation Index declined by 2.4%, with the share price performances of individual stocks varying significantly *(**Figure 1**)*.

Top of the winners list was the positive 25% return for GUD Holdings (***GUD***), a provider of largely non-discretionary automotive parts, through to the biggest loser, a negative 33% return for Domino's Pizza (***DMP***) which delivered weak results as management unsuccessfully tried to pass cost increases through to customers.

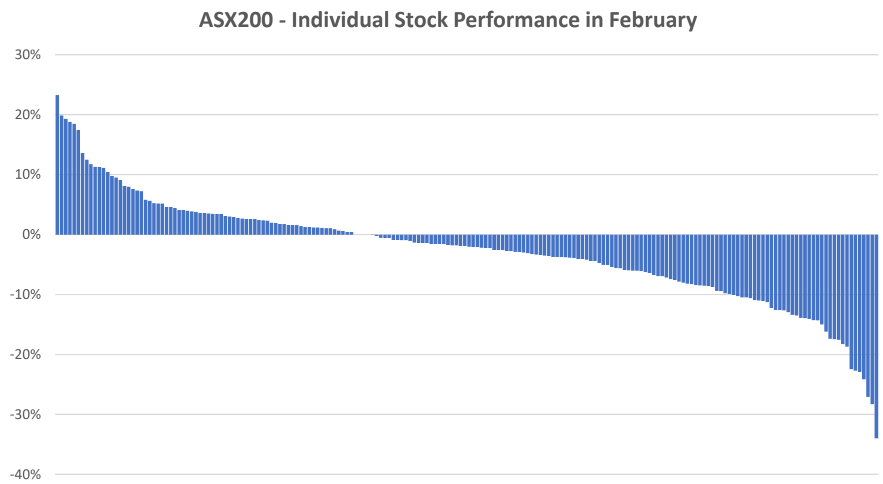

***Figure 1** – ASX200 – Individual Stock Performance in February (Source: IRESS)*

Overall, relative to individual company expectations, results were slightly on the disappointing side as monitored by FNArena (***Figure 2***).

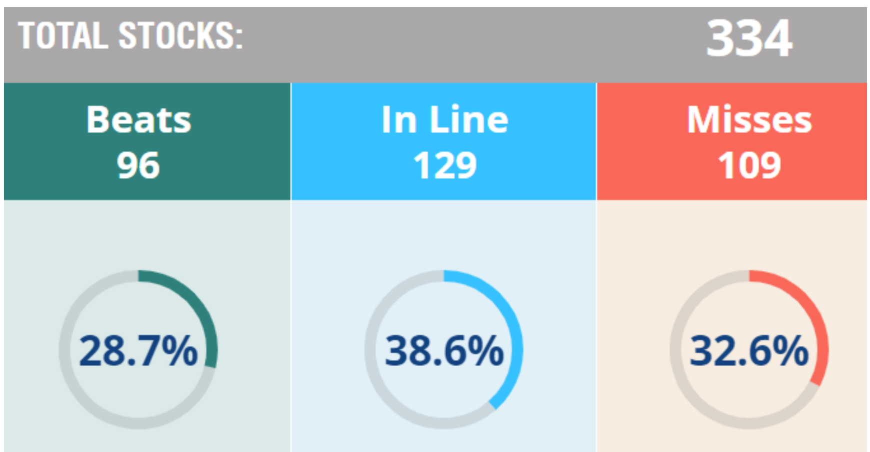

***Figure 2** – Company results versus market expectations (Source: FNArena)*

Portfolio Holdings

Below we provide brief commentary on some of the core companies held within the portfolio.

BHP Group Limited (ASX:BHP)

- *Underlying Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA) of US$13.2bn, down 28% on lower average Iron Ore and Copper prices.*
- *Interim dividend of US$0.90 / share.*
- *BHP's balance sheet remains strong with net debt of US$6.9bn, representing gearing of 13%, within BHP's target range of 5-15%.*
- *In the short-term BHP expects strengthened activity in China to offset the slow down being seen across the US, Japan and Europe.*
- *Over the longer-term, driven by population growth, rising living standards and the infrastructure required for decarbonisation, BHP expects these elements to drive demand for steel, non-ferrous metals and fertilisers for decades to come.*

Portfolio Action: We have recently reduced portfolio holdings of BHP following a ~25% rise in BHP's share price in recent months, coming on the back of a very strong recovery in Iron Ore prices. As a high-quality operator of significant Tier 1 global assets, with a strong balance sheet and a shareholder friendly capital allocation focus, we continue to regard BHP as a cornerstone holding within your portfolio.

Commonwealth Bank (ASX: CBA)

- *Cash Net Profit After Tax (NPAT) of $5.2bn, up 9%.*
- *Interim dividend of $2.10 / share, up 20%.*
- *CBA notes that the fundamentals of the Australian economy (low unemployment, strong exports and returning migration) remain solid. On the back of this, CBA is optimistic that a soft landing can be achieved for the Australian economy and remains positive on the medium-term outlook for Australia.*
- *This was a solid result from CBA and again highlighted to us why it remains the best performed of the Big4 banks.*
- *While there are well-publicised concerns over the economy, we think that the biggest risk to CBA (and other banks) may be from a regulatory standpoint. Banks in general are an easy target for politicians and the current Government has shown that it is not afraid to float policies that may be detrimental to certain sectors.*

CSL Limited (ASX: CSL)

- *Net Profit After Tax (NPAT) of US$1.96bn, up 10%.*
- *Interim dividend of US$1.07 / share.*
- *CSL's recent acquisition, Vifor, made its initial earnings contribution during the period, with management remaining confident as to its future prospects.*
- *Long-time CEO, Paul Perrault, retires from CSL on 6 March 2023, to be replaced by current Chief Operating Officer Paul McKenzie. The departure of a long-serving, well-regarded CEO can sometimes be a cause for concern. However, CSL has a good track record in this regard and with Mr McKenzie being an internal appointment, this should further reduce the risk that an error has been made.*
- *CSL maintained its FY23 net profit guidance of US$2.7-2.8bn.*
- *Longer-term we think CSL's outlook remains solid, underpinned by the strong tailwinds of a growing and aging population requiring ongoing care.*

GPT Group (ASX: GPT)

- *GPT's result was for the full year 2022 as it has a December financial year end.*
- *Distribution per unit of $0.25 was paid in 2022, in line with guidance.*
- *Net tangible assets of $5.98 / unit, down 1.8%.*
- *Overall portfolio occupancy of 97.5%.*
- *By division, GPT notes that its Retail division is well-positioned (99% occupancy), Logistics is strong (99% occupancy), while Office is challenging (88% occupancy).*
- *While noting that increased debt costs will be a headwind, GPT expects to deliver a distribution in 2023 of $0.25 / unit, in line with 2022.*
- *While the sector is facing headwinds, we think that the solid yield (~5.5%) and large discount to NTA (~20%) provides reasonable income with a solid margin of safety based on the value of assets held on balance sheet.*

REA Group. (ASX: REA)

- *Net Profit After Tax (NPAT) of $205m, down 9%.*
- *Interim dividend of $0.75 per share.*
- *Highlighting REA's pricing power, average price rises of 6% have been implemented. In addition to which increased up-selling to premium products saw the average "Buy Yield" (effectively revenue per advertisement) increase by 11%.*
- *Listing volumes declined 9% over the six months, including a 21% drop in the December quarter, reflecting conditions in the residential property market.*
- *While the short-term conditions are clearly quite weak, we remain very positive on the long-term outlook for REA's core Australian listings business. We are more circumspect on the investment being made into the Indian business, though acknowledge that should REA achieve success in this market, the pay-off could be material.*

Wesfarmers Limited (ASX: WES)

- *Net Profit After Tax (NPAT) of $1.4bn, up 14%.*
- *Interim dividend of $0.88 per share.*
- *Overall, WES portfolio businesses delivered solid results, with the improvement in the performance of Kmart / Target a highlight. Offsetting this to some extent was the ongoing issues with WES online business Catch.*
- *With a focus on providing value for customers WES believes that its businesses remain well-placed as consumers become more value conscious.*
- *In our "December 2022 Year in Review" we discussed WES "hidden" lithium assets, believing these assets to be under-appreciated by the market as the majority of major bank analysts covering WES are focussed on its retail businesses.*
- *WES noted that delays of ~6 months to first production at its under-construction lithium hydroxide plant are now expected, pushing this back to the start of 2025. Additionally, expected construction costs have escalated by ~$300m.*
- *While the delay and increased costs unfortunately appear to be a fact of life in the current environment, we do not see that this takes away from the potential long-term earnings power of this asset.*
- *We expect that over the coming 12-24 months, analysts from the major investment banks that follow WES will start factoring in the (potentially significant) value of the lithium assets.*