Entrust

Reporting Season Update

February 2024

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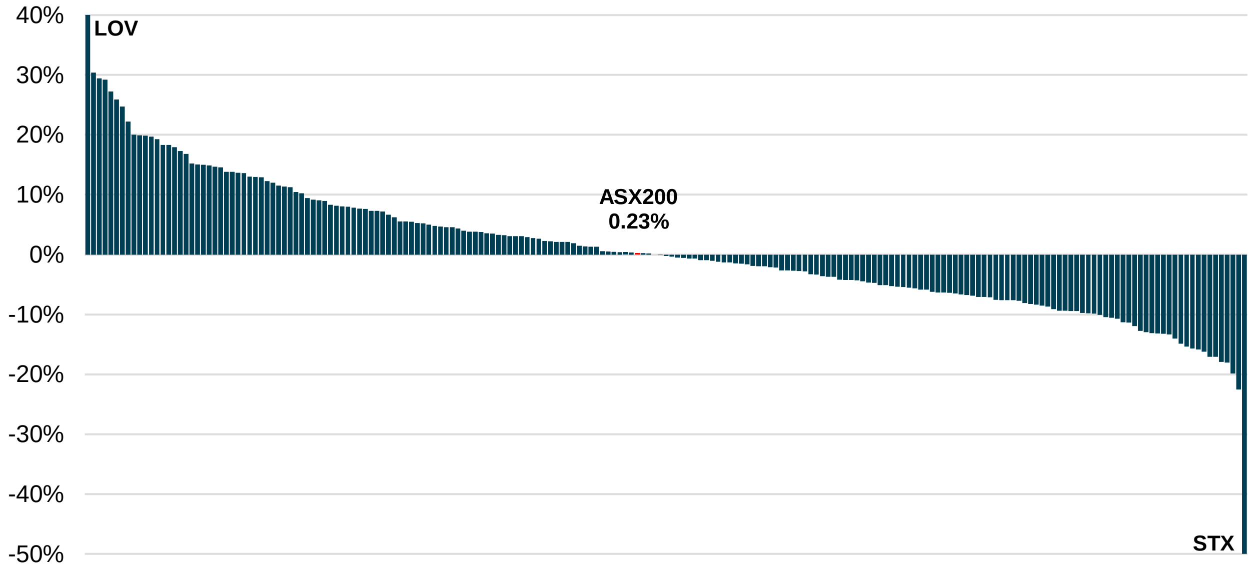
During February 2024, the ASX200 index gained 0.2%, while the ASX200 Accumulation Index (including dividends) gained 0.8%. The average individual stock return (excluding dividends) was 0.8%.

The moderate increase in the overall performance of the index belied the underlying volatility of changes in individual stock prices. Across February, 62% of companies experienced share price moves* of 5% or greater. **Figure 1** shows the dispersion of share price returns across the month. The best performing stock, adding 40%, was fast-fashion jewellery retailer Lovisa. Oil & gas play Strike Energy lost 50% in value, due to poor drill results, while the poorest performer on the back of reported financial results was Corporate Travel Management, with a 23% share price decline.

The performance disparity was also echoed across sectors **(Figure 2)** with the Information Technology and Consumer Discretionary sectors performing strongly, offset by Energy and Materials, along with those sectors generally considered to be more defensive in nature, including Health Care and Consumer Staples.

Figure 1: ASX200 – Individual Stock Performance in February

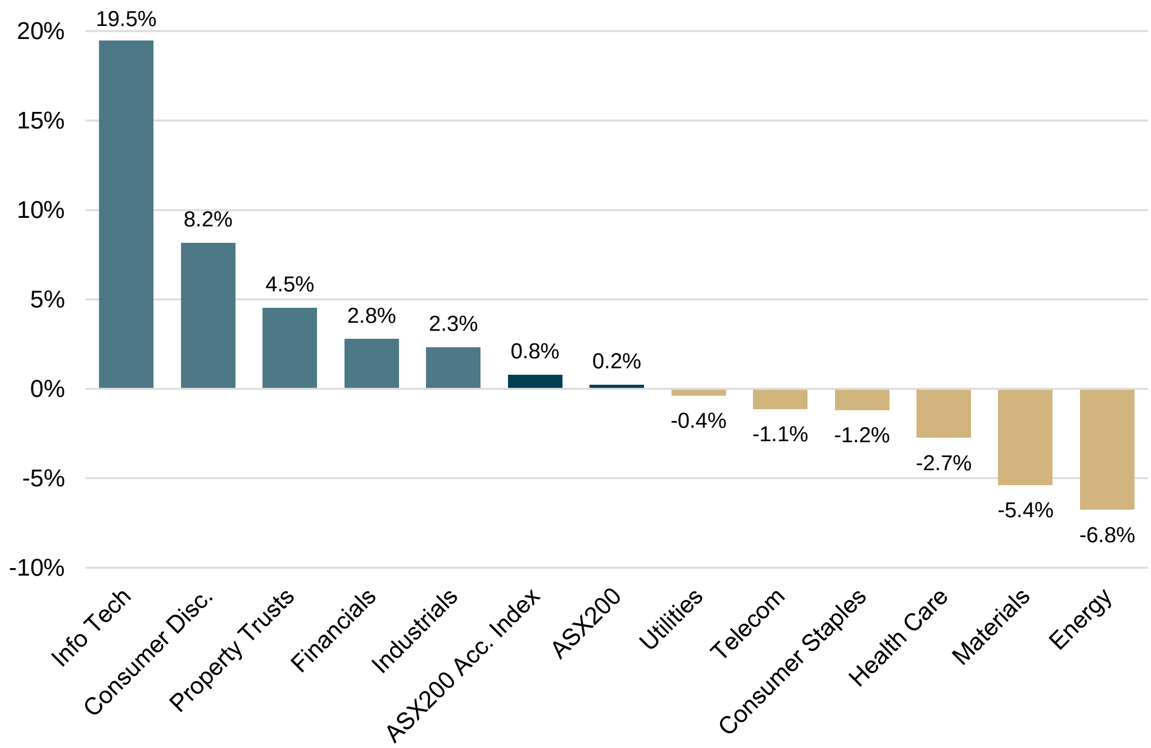


Source: Iress

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

** Excluding the impact of dividends.*

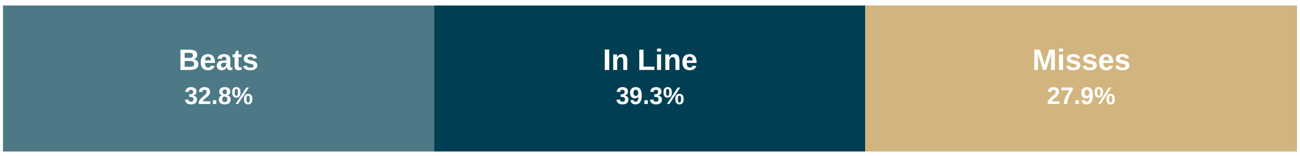
Figure 2: ASX200 – Performance by Sector



Source: Iress

Relative to market expectations, results of more than 350 companies across the ASX200 and the ASX more broadly, as tracked by FNArena, were generally seen to be more positive than negative **(Figure 3)**.

Figure 3: 1H24 Reporting Season – Results versus Expectations



Source: FNArena

Key Themes & Features: What companies are saying

Below, we discuss some of the key themes coming out of reporting season. In general, the commentary is not too dissimilar to that seen coming out of the August 2023 reporting season.

Domestic economy continues to show resilience

The Big 4 Banks (CBA reported results, other majors provided trading updates) across the board noted the general resilience of the economy, being supported by a strong labour market, population growth (via immigration) and high commodity prices. The banks noted that while arrears had ticked up, they remain at historically low levels.

Consumers continue to seek value

An extension of what we started to hear coming out of the August 2023 results; as consumers tighten their belts' they continue to seek out better value. As expected, this played to the strengths of those quality retail companies with a well-earned reputation for providing the lowest prices: Wesfarmers (WES) (the owner of Bunnings, Kmart & Target) and JB Hi-Fi (JBH) (the owner of JB Hi-Fi and The Good Guys).

Companies doing a good job managing inflationary cost pressures

It had been well-flagged by a number of companies for some time that managing cost pressures would be more of a challenge entering the 2024 financial year. This was primarily due to rising inflationary costs, particularly mandated increases in the minimum wage, increases in energy costs and rental increases, with many rental agreements stipulating annual cost growth tied to changes in CPI. In general, companies appear to have prepared well and performed a solid job in managing these cost impacts, particularly in an environment that saw growth in the revenue line slow.

Regulatory risk remains ever-present

Usually, it is the Banks that make easy targets for politicians and the like given the large headline profit numbers they generate (an argument which generally and conveniently ignores the size of the asset base required to generate such profits). We didn't detect a peep of complaint toward the Banks during this reporting season. It was however the turn of the major Supermarkets (WOW and COL) to catch the ire of politicians for alleged price gouging, which will be the subject of an ACCC enquiry expected to last into early 2025.

Global markets and global capital

Rob Scott, MD of Wesfarmers, in noting how important it is to have policy settings that help Australian business, was quoted in an interview saying *"sometimes I think that governments forget the fact that we are in a competitive global market, and investors have opportunities to invest their capital in different projects in different parts of the world".*

Along these lines, BHP advised that they will not be investing any further growth capital into Queensland given "*the negative impact on investment economics resulting from the change in coal royalty rates, and the increase in sovereign risk due to the decision to raise royalties without consultation."*

Industrial relations as a pressure point

In line with the above, a number of major employers raised concerns around the potential changes to industrial relations under the Federal Government's "Same Job Same Pay" reforms and what this may ultimately mean for business productivity, amongst other concerns.

REITs see further valuation declines

Real Estate Investment Trusts (REITs) in general reported valuation declines across their portfolios as Capitalisation rates (one of the key inputs into property valuations) continued to increase. More specifically, across the key asset sectors, *Retail* performed strongly with healthy occupancy rates and rental increases feeding through. *Logistics* remained a sector of strength as leasing spreads (rents charged under new agreements versus rents under old agreements) saw very strong growth; GPT noted average leasing spreads of 39% across its Logistics division. *Office* remains in a tough spot, with vacancy rates stubbornly high and transaction activity muted, in part given the gap between the differing expectations of buyers and sellers.

Artificial Intelligence "AI"

The latest *"buzz-word";* a number of companies discussed AI. How it ultimately plays out from here is hard to know; from the industries and companies that will be beneficiaries and those that will be disrupted.

We would expect that over time a number of companies will be able to improve productivity through the use of AI in a variety of functions.

NVIDIA, the poster-child for the AI frenzy (and now the 3rd largest company in the world, by market capitalisation) reported its results in the US on 21st February, following which the ASX200 Information Technology sector jumped 8% over the remainder of the month, while the broader ASX200 gained 1%.

Whether or not NVIDIA actually has a meaningful impact on ASX companies is debatable, though we have clearly seen that it has had an impact on investor sentiment toward the Aussie Tech sector.

Iron Ore the commodity stand-out

In a period where many commodities experienced price declines (of particular interest for Western Australia, most notably lithium and nickel), the Iron Ore price remained stronger than most had expected throughout the period, driving strong results from the Big 3 Iron Ore producers (BHP, RIO, FMG).

Interestingly, BHP noted that the cost of mining production continues to be higher than it was prior to the pandemic. It was implied that price support is also expected to be higher than in previous cycles and low-cost operators stand to capture potentially higher relative margins in certain commodities.

We expect that the outlook for China will continue to be the dominant factor impacting the Iron Ore price into the future.

Core Portfolio Holdings

Below we provide brief commentary on the core portfolio holdings that reported their financial results over the period. We have also provided similar commentary on a number of companies that are currently on our "watch list".

Commentary related to "profits" refers to the key earnings metric highlighted by each company. Many companies these days focus on a line other than Net Profit after Tax (NPAT) and may for example use Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA).

While EBITDA has become more common as a metric, it is worthwhile keeping in mind that this excludes numerous charges that impact upon the cash ultimately generated by the business, and available for reinvestment and/or returns to shareholders.

Warren Buffett recently wrote that *"EBITDA is a banned measurement at Berkshire"*, whilst his recently departed business partner, Charlie Munger, has been more characteristically direct, noting that *"Every time you see the word EBITDA, you should substitute the words "bulls**t earnings".*

BHP Group Limited ASX: BHP

Underlying EBITDA of US$13.9bn up 5% on 1H23 (US$13.2bn).

- Underlying NPAT of US$6.6bn was in line with 1H23.
- Reported NPAT of US$0.9bn was impacted by write-downs of US$5.7bn related to BHP's Western Australian nickel operations (US$2.5bn) and the 2014 Samarco dam failure in Brazil (US$3.2bn).
- An interim dividend of US$0.72 per share (1H23 US$0.90) was declared.
- Net debt at period end was US$12.6bn, comfortably within BHP's target range of US$5-15bn.
- Iron Ore was again the key driver of the result generating EBITDA of US$9.7bn, while Copper (US$3.5bn) and Coal (US$1.0bn) also contributed.
- In regard to the long-term, BHP expects that *"population growth, rising living standards, and the infrastructure required for global decarbonisation will drive demand for steel, non-ferrous metals and fertilisers."*
- In relation to the key global Iron Ore consumer, China, BHP notes:
  - *"For the balance of FY24 and into FY25, the key question remains how effective China's policy push will be. Until we see greater coherence between the policies and their effective implementation, our outlook will remain cautious and conditional."*
  - *"In the medium term, China's demand for iron ore is expected to be lower than it is today… though we expect demand for our products from elsewhere in developing Asia will offset this to a degree."*
- BHP ramped up its language in regard to labour productivity in Australia, noting *"the labour market remains a core inflationary concern, with aggregate wage outcomes in Australia increasingly disconnected from underlying productivity performance, which has been historically weak. This concern is amplified by regulatory reform underway in Australia, which will add to our labour costs and reduce the international competitiveness of the Australian economy."*
- ***BHP's earnings are heavily reliant on commodity prices, however with Tier 1 assets and its solid balance sheet, we see BHP as providing a quality resources exposure that is well-placed into the future.***

Commonwealth Bank ASX: CBA

Cash NPAT of $5.0bn, up 3% on 2H23 ($4.9bn); down 3% on 1H23 ($5.2bn).

- An interim dividend of $2.15 per share (1H23 $2.10) was declared, reflecting a payout ratio of 72%, within CBA's target range of 70-80%.
- Competition, particularly across Home Loans and Deposit accounts saw Net Interest Margins (NIMs) decline 6 basis points (bps) to 199bps from 205bps in 2H23.
- The Personal Lending book is in good shape, with arrears remaining historically low across Home Loans, Credit Cards and Personal Loans.
- In regard to the outlook CBA notes:
    - *"The economy has been fairly resilient, supported by a strong labour market, savings and repayment buffers, population growth and relatively high commodity prices. However, downside risks are building as slowing demand and persistent inflation impact Australian businesses."*
    - *"As cash rate increases have a lagged impact on households and business customers, we expect financial strain to continue in 2024, with an uptick in our arrears and impairments."*
    - Notwithstanding the above points, overall CBA remains *"optimistic about the outlook for the Australian economy"*.
- Amongst the Big 4 Banks, CBA maintained its position as Number 1 in Net Promoter Scores across all key business segments; Retail, Business and Institutional.
- ***CBA is by far the largest of the Big 4 banks and has for many years been the best performed in regard to key measures such as Return on Equity and growth in Earnings per Share. We think the business is positioned well to continue this performance into the future.***

CSL Limited ASX: CSL

NPAT of US$2.1bn, up 13% on 1H23 (US$1.8bn).

- An interim dividend of US$1.19 per share (1H23 US$1.07) was declared.
- Net debt remains elevated at US$11.1bn post funding of the August 2022 Vifor acquisition.
- There were a few disappointments for CSL:
    - The day prior to the result, CSL announced that Phase 3 trial results for its CSL112 drug were not successful. While no earnings were being factored into future forecasts for CSL112, the market was anticipating success with this drug.
    - In relation to Vifor, CSL commented that *"while the strategic potential of the business remains strong, we have dampened our near-term growth aspirations for CSL Vifor."* While CSL has a strong track record in delivering on acquisitions, this is a disappointing outcome, notwithstanding management remains confident in the longer-term potential of Vifor.
- More positively, the core Behring division reported strong results, with revenue growth of 14% to US$5.1bn and margins trending upward, which had been a key focus of investors.
- In regard to the outlook:
    - CSL re-affirmed FY24 NPAT guidance of US$2.9-3.0bn.
    - Longer-term, CSL notes that it is *"in a strong position to deliver annualised double-digit earnings growth over the medium term"*.
- ***CSL has strong tailwinds, positioning it well to achieve strong earnings growth over the longer-term. Shorter-term, any further disappointments may see the pressure ratchet up on relatively new CEO Paul McKenzie.***

GPT Group ASX: GPT

GPT reported its FY23 result as it has a December year end.

- GPT reported a Statutory Net Loss of $240m, largely related to negative property revaluations of $819m.
- Excluding the property revaluations, GPT delivered Funds from Operations (FFO) of $601m, in line with guidance and down 3% on FY22 ($621m).
- Net Tangible Assets (NTA) reduced by ~4% to $5.61 per share from $5.85 per share at 30 June 2023, reflecting the decrease in valuations due to the ongoing impact of rising interest rates partially offset by increasing rents received.
- Balance sheet remains in good shape with gearing of 28.3%, well within the 25-35% target range.
- Occupancy across GPT's asset portfolio was 98.2%, with Logistics (99.5%) and Retail (99.8%) both very strong, while unsurprisingly Office remains challenging (92.3%).
- Guidance for FY24 is for a slight decrease in distributions to $0.24 per unit, from $0.25 in FY23.
- ***GPT is a well-managed property trust of significant scale ($33bn of Assets Under Management) with a solid balance sheet. GPT currently trades at a discount of ~20% to its NTA, suggesting that the share price contains a material margin of safety and provides reasonable upside potential. Additionally, the distribution guidance implies an unfranked dividend yield of ~5.5%.***

Pilbara Minerals Ltd ASX: PLS

Underlying NPAT of $273m down 78% on 1H23 ($1,242m).

- The large drop in earnings is reflective of the precipitous fall seen in lithium prices over the period. PLS achieved an average realised spodumene price during 1H24 of US$1,645/t, down 67% on 1H23 (US$4,993/t).
- No interim dividend was declared (1H23 $0.11 per share).
- PLS maintains a very strong balance sheet with net cash at period end of $1.8bn. This is down from $3.1bn at 30 June 2023 and amongst other movements, reflects a combination of tax payments ($0.9bn), dividends ($0.4bn) and capital expenditure ($0.4bn).
- PLS continues to progress both the P680 and P1000 expansion projects, with additional capex of $420-475m expected in 2H24.
- ***With its very strong balance sheet, and importantly a management team acutely aware of the importance of maintaining this balance sheet strength, we remain comfortable with PLS providing our exposure to the positive long-term outlook for lithium, notwithstanding the highly volatile short-term swings we are seeing.***

ResMed Inc. ASX: RMD

Underlying 2Q24 NPAT US$277m, up 13% on 2Q23 (US$244m).

- RMD reports its results quarterly as its prime listing is on the New York Stock Exchange.
- 2Q24 results were strong and importantly showed improvement in Gross Margins, an area that investors had been focussing on, given margins had been weaker than expected in prior periods.
- Separate to RMD's results, other announcements have been also positive:
  - In mid-January RMD released details of a comprehensive study of over 500,000 patients, suggesting that anti-obesity drugs (AODs) are more likely to be beneficial in driving greater demand for RMD's products, as opposed to prior market concerns that AODs may be a significant negative on RMD's business.
  - One of RMD's key competitors, Respironics (a division of Philips) had a product recall in the US in 2021. It had been expected that Respironics would have been back competing in the US market by now. However, it now looks that subject to an agreement with the US Food & Drug Administration (FDA) Respironics will be out of the market for upwards of a further 5-7 years.
- ***RMD is the global leader in its field, backed by strong long-term demand tailwinds (e.g., ageing population, increasing obesity, increased awareness of sleep apnoea), positioning the business well over the longer-term.***

Santos Ltd ASX: STO

STO reported its FY23 result as it has a December year end.

- STO reported FY23 Underlying NPAT of US$1,423m, down 42% on FY22 (US$2,461m) as a result of lower average oil prices.
- Free cash flow from operations of US$2,128m was generated, down 42% on FY22 (US$3,641m).
- A final dividend of US$0.175 per share was declared, bringing total dividends for the year to US$0.262 (FY22 US$0.227).
- Balance sheet remains solid with net debt of US$4.3bn and gearing of 18.4%.
- STO continues its heavy capex phase with major projects Barossa (~US$700m) and Pikka (~US$500m) comprising the lion's share of the ~US$1,600m in committed capex for major projects in FY24.
- Importantly, STO has re-started work on the Barossa project following delays caused by legal challenges. Barossa is expected to deliver first gas in 3Q 2025.
- Toward the end of 2023 it was announced that STO and Woodside (WDS) were in preliminary discussions concerning a possible merger. Discussions were ultimately terminated in early February 2024. Notwithstanding this, it would not be a surprise were STO to be the subject of corporate interest at some stage.
- ***In the current environment with energy security front of mind, we believe that exposure to a well-managed, cash generative energy business is appropriate for client portfolios.***

Wesfarmers Limited ASX: WES

Net Profit After Tax (NPAT) of $1,425m, up 3% on 1H23 ($1,384m).

- An interim dividend of $0.91 per share (1H23 $0.88) was declared.
- Balance sheet remains in good shape with net debt of $3.9bn. WES has ~$2.4bn of available facilities, providing plenty of capacity should growth opportunities present.
- Bunnings (~58% of group earnings) was solid with revenue growth up 1.7% and divisional earnings up 3% to $1,282m,
- Kmart Group (~27% of group earnings) was the stand-out with revenue growth of 5% combining with ongoing productivity initiatives resulting in earnings growth of 26% to $601m.
- Management, understandably, was very positive on the outlook for Kmart, given the strong value credentials for which it is known. Kmart's 100%-owned Anko brand is proving to be a key point of difference.
- WES 50/50 Lithium JV, Covalent, saw good progress during the period with the Mt Holland concentrator successfully commissioned. Construction of the lithium hydroxide facility at Kwinana is ~65% complete, with this facility expected to come on line by early 2025.
- It is very early days, for the WES' Health division, with management commenting that while they are happy with the progress being made on the transformation, they are not happy with the profitability and returns at present.
- ***WES is a very well-managed business with a shareholder friendly focus. The business has a strong balance sheet providing optionality. Over the medium to longer-term we believe there is a high probability that WES will continue to grow earnings at high rates of return on capital.***

Watch List Holdings

Goodman Group ASX: GMG

Operating profit of $1,127m, up 29% on 1H23 ($876m).

- GMG recorded a Statutory Net Loss of $220m, largely on the back of negative property revaluations of $1.2bn as capitalisation rates continued to increase, negatively impacting valuations.
- An interim distribution of $0.15 per share (1H23 $0.15) was declared.
- The balance sheet is in excellent shape with gearing at 9.0% and look-through gearing (including GMG's share of debt held in co-investments) of 22.7%.
- Portfolio occupancy remained strong at 98.4%, with like-for-like growth in net property income of 5%. Additionally, GMG believes that its portfolio is "under-rented" (i.e., the level at which current contracted rents are below market rents) by ~25% on average, suggesting strong income growth potential as contracts come up for renewal.
- In regards to outlook:
  - GMG upgraded guidance for FY24 growth in Operating EPS from 9% to 11%.
  - Looking further ahead, GMG highlights that *"given positive structural trends, we expect continued customer and investor demand for our high quality industrial and digital infrastructure assets. Supply constraints in our locations are expected to continue to drive rental growth and maintain high occupancy rates across the portfolio."*
- ***GMG is excellently managed, has a strongly positioned portfolio and maintains a balance sheet that provides the ability to take advantage of opportunities that may present.***

JB Hi-Fi Limited ASX: JBH

NPAT of $264m, down 20% on 1H23 ($330m).

- An interim dividend of $1.58 per share (1H23 $1.97) was declared.
- Balance sheet is in excellent shape with net cash of $488m.
- Profits have finally come down from the COVID-stimulus induced highs of recent years, however it is worth noting that NPAT was up 55% when compared to 1H20 (the last pre-COVID result).
- At its FY23 result JBH outlined expected FY24 cost pressure challenges - mandated 5.75% minimum wage increases, Victorian payroll tax (JBH is headquartered in Melbourne), increased rental expenses and increased energy costs. Unsurprisingly JBH appears to have managed this environment well, with expense growth of 5.2%.
- JBH noted that the retail environment is challenging, with heightened competition and increased discounting being seen.
- With its well-earned reputation for providing the lowest prices and best value, coupled with its position as having the lowest cost of doing business, we think JBH is well-placed, certainly relative to the competition, in the current environment.
- ***JBH is an excellently managed business, with each of its brands being the Number 1 player in their respective markets. JBH has a very strong balance sheet, strong cash generation and capital management policies favourable to shareholders.***

Transurban Group ASX: TCL

EBITDA of $1,331m, up 7% on 1H23 ($1,238m).

- Interim distribution of $0.30 per share (1H23 $0.265) was declared.
- Average daily traffic grew 2.1% to over 2.5m trips per day across the TCL network. Combined with toll increases, this resulted in revenue increasing by 6.3% to $1,763m.
- TCL's balance sheet remains well-managed with 95% of debt hedged and a weighted cost of debt of 4.3%.
- In regard to outlook, TCL confirmed FY24 distribution guidance of $0.62 per share and commented:
  - *In the short-term, earnings growth across the business is supported by solid traffic growth and disciplined cost management.*
  - *Longer term, we are well positioned to deliver disciplined growth through existing opportunities, supporting the significant population growth that is forecast in key markets and emerging mobility trends.*
- TCL is very much a bond-like exposure and as such sees its valuation impacted by movements (and expected movements) in interest rates.
- ***TCL is very well-positioned as Australia's dominant (monopoly) operator of toll roads. Over time this should see ongoing growth in distributions to shareholders through population growth-inspired increases in traffic coupled with the inexorable growth in toll charges (~70% of TCL toll road concessions have CPI-linked increases).***

Woolworths Group Ltd ASX: WOW

Underlying Net Profit After Tax (NPAT) of $929m up 2.5% on 1H23 ($907m).

- Statutory NPAT was a loss of $781m on the back of a $1.5bn impairment charge against WOW's New Zealand Food operations and a $0.2bn mark-to-market loss on WOW's holding in Endeavour Group (EDV).
- An interim dividend of $0.47 per share (1H23 $0.46) was declared.
- To say that WOW has had an eventful period is an understatement:
  - The backlash from the decision to not stock Australia Day merchandise.
  - In late January an ACCC enquiry to examine prices and competition in the supermarket sector was announced. The enquiry is expected to take one year.
  - A few days prior to announcement of the 1H24 result Managing Director Brad Banducci appeared in a Four Corners interview during which he threatened to walk out.
  - On the day of the result, Mr Banducci unexpectedly retired from his role, to be replaced by Amanda Bardwell, a veteran of 23-years with WOW.
- The result itself was solid and having been "pre-reported" to the market in late January was as expected. The big surprise was the departure of Mr Banducci, a very well-regarded executive who was widely considered to have done a very good job.
- ***The impending departure of Mr Banducci, brings a degree of uncertainty at a time when the sector itself is under the spotlight. As Australia's largest supermarket chain, providing largely essential products WOW remains an attractive defensive exposure.***

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