WILSONS

A Rising A$ and Company Earnings

Our weekly view on Australian equities.

20 August 2020

Differing Sensitivities to the A$

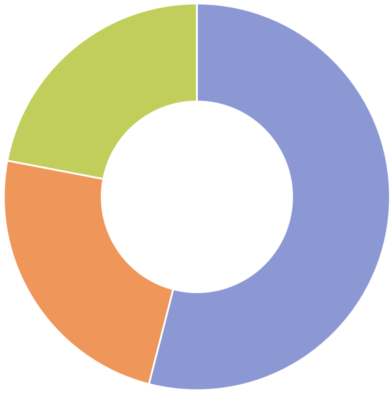
The proportion of market earnings sourced offshore for Australian companies has risen in recent years, with companies heading offshore to develop new markets and offshore earnings growing at a faster rate than domestic sourced earnings in recent years.

Today, around 25% of the S&P/ASX 100 earnings – ex-resources – are exposed to offshore earnings.

While the A$ at its current level of $0.71-$0.72 is moving toward the fair value zone, we still see some potential upside into the $0.75-$0.80 area over the next year or so. Clearly this has potential to more greatly impact companies with offshore exposure. And while the Australian Equity Focus List has a greater exposure to offshore earnings vs. the market, a number of natural offsets coupled with our overweight materials exposure will dampen its sensitivity to a potentially higher A$.

Here we outline the potential impact of a rising A$ on a number of Australian companies, explain why the resources sector is an outlier, and detail our continued investment case for the Australian Equities Focus List.

Exhibit 1: Offshore revenue exposure of the S&P/ASX 100



Domestic	**54%**
International Exposure	**24%**
Resources	**22%**

Source: Company Data, Refinitiv, Wilsons. Market Cap weighted. 2019 data used.

Mitigating the A$ Impact on Australian Equities

From a pure earnings perspective, as the A$ rallies the reported A$ earnings of a company fall due to pure translation effects.

The precise impact is difficult to gauge given the operating environment is dynamic and changes to the A$ do not tend to happen in isolation. However, there are ways companies can mitigate short-term currency fluctuations including:

1. Active FX hedging
2. Moving a portion of operations/financing offshore (a cost base offshore provides a natural hedge)
3. Re-pricing goods and services
4. Leaving the issue for investors by reporting in an offshore currency

Some companies, like CSL, attempt to isolate moves in FX by providing adjusted earnings numbers to the market which removes the noise of FX as 'constant currency' adjusted earnings better reflect the underlying level of earnings free from currency impacts.

In many cases, it's not the level of the A$ that creates earnings issues for companies, but the rate of change. Large swings in the A$ are hard for companies to adjust for, particularly in the short-term, with many retailers setting prices on an annual basis that leave them exposed to A$ fluctuations if unmitigated for new inventory. In the long-term everything is adjustable, giving companies the ability to fine-tune their operations to offset shifts.

What is the Market Saying About Foreign Currency Exposures?

We have split the market into three buckets of currency exposures:

1. High exposure: 25% of revenue offshore
2. Low exposure: 5-25% offshore
3. Domestic: <5% offshore revived revenue

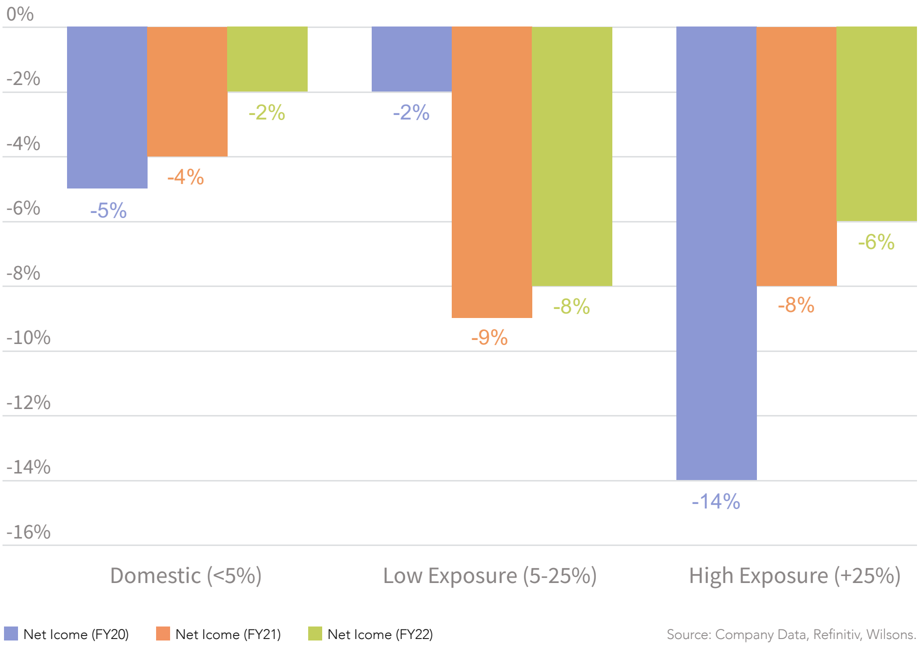
Market consensus earnings revisions (Refinitiv) over the last 3 months have already begun to factor in some impacts of the stronger A$ with negative revisions of ~ 8% for high exposure companies such as Altium (ALU), Brambles (BXB), Qantas (QAN), and Seek (SEK).

While not primarily due to the rising A$, there is a notable gap emerging in earnings revisions between companies with domestic exposed earnings vs. offshore. This compares to essentially flat revisions for largely domestic exposed companies such as Cleanaway Waste Management (CWY), JB Hi-Fi (JBH), Mirvac (MGR), Stockland (SGP), and the major banks.

Is There a Growth Differential Between Domestic and Offshore Exposures?

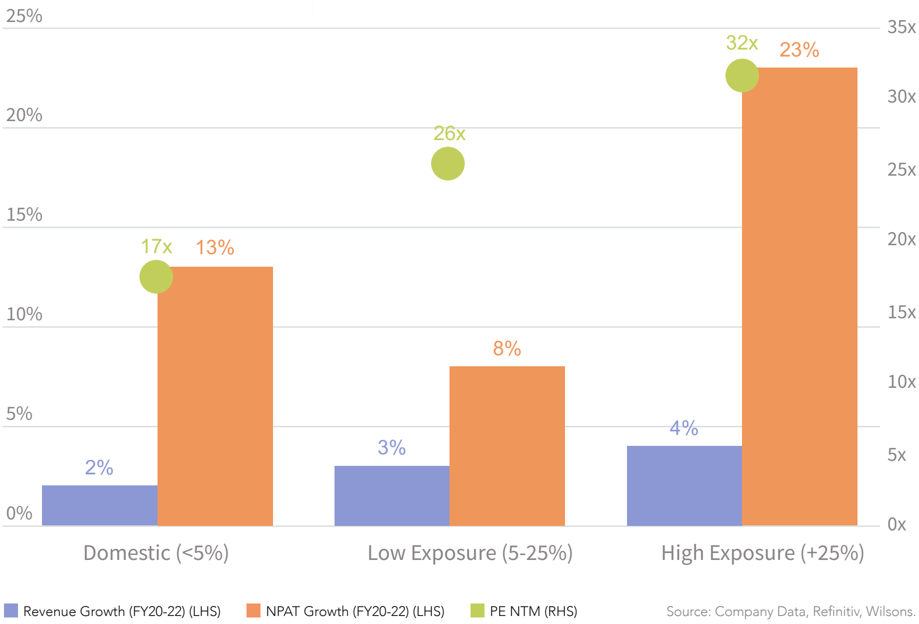
The market is currently assuming a much higher level of earnings growth from FY20E into FY22E for high exposure companies (23%) vs. domestic companies (13%). The price to earnings ratio (PER) multiple is also significantly higher at almost 30x vs. 17x for domestically exposed companies. This potentially leaves earnings and valuations of high exposure companies vulnerable to any rapid appreciation in the A$.

Exhibit 2: 3mth consensus earnings revision by A$ exposure



Source: Company Data, Refinitiv, Wilsons.

Exhibit 3: Revenue and NPAT growth % (FY20E-22E) and 12mth forward PER (x) by A$ exposure



Source: Company Data, Refinitiv, Wilsons.

Assessing the Sensitivity of Earnings to a Higher A$

To assess the sensitivity of earnings to a higher A$ we have constructed a simple linear model. For simplicity, the model assumes companies are unable to mitigate the impacts of the higher A$ and our analysis is limited to A$ against the $US, which is the most significant exposure. In reality, companies are exposed to a broad range of currencies.

Assuming a rise of the A$ to $0.80, for companies with ~50% of earnings exposed offshore, earnings would need to be revised down by around ~5%. Whether the market gets overly concerned about this remains to be seen, particularly against the backdrop of a potential global recovery and an environment where earnings growth above GDP is challenging.

Our view is currency will largely be manageable for most highly exposed companies up to ~$0.80. Beyond $0.80, the market could begin to get concerned, potentially resulting in underperformance of companies with large offshore earnings.

Exhibit 4: Linear model of earnings sensitivity to a higher A$

	% Earnings Offshore							
AUD / USD	**10%**	**30%**	**40%**	**50%**	**60%**	**70%**	**80%**	**90%**
0.68	100.7	102.1	102.8	103.4	104.1	104.8	105.5	106.2
0.70	100.3	101.0	101.4	101.7	102.1	102.4	102.8	103.1
0.73	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
0.75	99.7	99.0	98.6	98.3	97.9	97.6	97.2	96.9
0.78	99.3	98.0	97.3	96.7	96.0	95.3	94.7	94.0
0.80	99.0	97.1	96.1	95.2	94.2	93.2	92.3	91.3

Source: Company Data, Refinitiv, Wilsons.

Potential $A impact on the Australian Equity Focus List

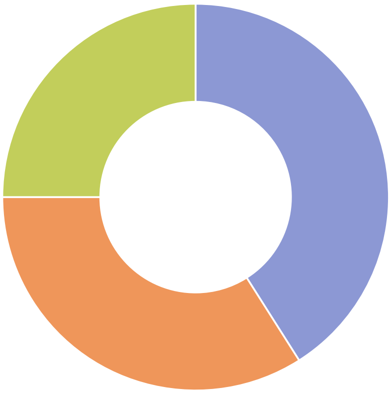
The Focus List is more heavily exposed to offshore earnings compared to the market—an outcome of the largely bottom-up investment process used to identify companies with above average growth prospects, rather than a specific push to get exposure offshore.

Many of the companies in the Focus List that display compound earnings growth potential have large global markets for their products. The A2 Milk Company (A2M), Aristocrat Leisure (ALL), Amcor (AMC), Appen (APX), CSL (CSL), Goodman Group (GMG), James Hardie Industries (JHX), ResMed (RMD) and Xero (XRO) are all offshore focused and have strong, globally-relevant competitive advantages that have allowed them to develop offshore growth opportunities.

While the A$ at its current level of $0.71-0.72 is moving toward the fair value zone, we still see some potential upside into the $0.75-0.80 area over the next year or so. In our view, this should not materially impede the investment case for this group of stocks. A more bullish view on the A$ or a sustained period above $0.80 would potentially threaten our investment case on some companies.

A number of companies are likely to exhibit positive earnings leverage to an improving global economy that is likely to act as a natural offset to a higher A$, such as Aristocrat Leisure (ALL), CSL (CSL), James Hardie Industries (JHX), Macquarie Group (MQG), and News Corp (NWS).

Exhibit 5: Australian Focus List A$ exposure by geography



Domestic	**41%**
International Exposure	**34%**
Resources	**25%**

Source: Company Data, Refinitiv, Wilsons. Exposure weighted by Focus List weighting

Why the Resources Sector is an Outlier

A rising A$ impacts the materials and energy sectors, or more broadly the resources sector, differently to other sectors.

Earnings translation impact remains, but the revenue lines for resource companies are exposed to commodity prices. Traditionally a key factor behind a rising A$, the two often move hand-in-hand.

Rising commodity prices can often provide a large offset for resources sector' earnings under pressure from a rising currency. Share prices generally also follow the movement in commodity prices.

In a globally cyclical upswing, not only are commodity prices rising but so too is investor interest in cyclical sectors like resources. As a consequence, we consider the resources sector to be a net beneficiary of a rising A$.

This provides some counter balance to the Focus List's offshore exposures, with the Australian Equity Focus List overweight the resources sector.

Read our recent macroeconomic view for more.

Exhibit 6: Australian Focus List A$ exposure

Company	Exposure	3M FY21E NPAT revision	ISG comment
Financials			
ANZ	Domestic	-2%	AUS/NZ asset base
CBA	Domestic	-6%	AUS/NZ asset base
Macquarie Group	High exposure	-1%	Both cost base (people) and funding offshore in similar ratio
Industrials			
Aurizon Holdings	Domestic	-8%	AUS asset base
Seven Group Holdings	Domestic	0%	Significantly an Australian asset base
Transurban Group	Low exposure	-41%	~10% of asset base in located in the US
Consumer Staples			
Costa Group Holdings	Domestic	0%	New assets being developed in China/Morocco
The a2 Milk Company	High exposure	1%	Predominately China, small exposure in US
Consumer Discretionary			
Appen Group	High exposure	6%	Global business, overweight US
Aristocrat Leisure	High exposure	-15%	Global business, operations overweight US
Collins Foods	Low exposure	21%	~15% of assets located in EU
Materials			
Amcor	High exposure	-10%	The acquisition of Bemis further lifted AMC offshore exposure
BHP Group	Resources	-3%	Typically positvely exposed to a higher $A
James Hardie Industries	High exposure	22%	Operations are ~70% US, with EU and Asia the balance
Northern Star Resources	Resources	-2%	Typically positvely exposed to a higher $A
OZ Minerals Limited	Resources	20%	Typically positvely exposed to a higher $A
Rio Tinto Group	Resources	7%	Typically positvely exposed to a higher $A
Health Care			
CSL	High exposure	-12%	Global business, operations overweight US
ResMed	High exposure	-7%	Global business, operations overweight US
Telix Pharmaceuticals	High exposure	n/a	
Real Estate			
Goodman Group	High exposure	2%	Global business, operations overweight EU
Information Technology			
Link Administration	High exposure	-11%	Larger EU/UK exposures following recent acquisitions
Xero Limited	High exposure	-2%	Increasing global asset base
Communication Services			
News Corporation	High exposure	-15%	Global business, overweight US
Energy			
Santos Limited	Resources	20%	Typically positvely exposed to a higher $A

Source: Company Data, Refinitiv, Wilsons.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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