Reporting Season: 2022 Earnings Recovery Still Visible

Our weekly view on Australian equities.

02 February 2022

Omicron Casts a Shadow

February reporting season will have everything to talk about but little to show in terms of earnings growth. The Omicron variant, which ripped through much of the country over summer, has cast a shadow on the near-term earnings recovery.

A shadow lockdown was in place for much of the summer with government or simply self-imposed mobility restrictions. Few sectors have escaped the impact but materials, energy, and financials have been minimally impacted.

Earnings are still expected grow half on half (1H22 vs 2H21), albeit now at low single-digits in this reporting season. For 2022, consensus estimates imply ~10% EPS growth over 2022, with industrials, energy, and technology sectors leading the way.

It is worth noting that since earnings recovery for Australian equities started in 3Q20, the upward revision cycle has only been broken by COVID-19 interruptions. There remains a risk that Omicron may lead to consensus earnings downgrades over February.

While this result season is likely to carry a lot of noise around the still lingering impacts of COVID-19, we remain optimistic that Australian earnings can still grow in 2022. This view is underpinned by:

1. Optimism that we will see a cleaner COVID-19 reopening this half
2. Buoyant commodity prices with spot prices implying material sector earnings +70% higher
3. Improved bank earnings (rising bond yields will begin to assist here)

Importantly from a price perspective, the relative cyclicality of Australian earnings (particularly vs US earnings) suggests the Australian market can still deliver mid-high single-digit returns this year, even against a potential backdrop of rising global interest rates (and likely RBA rate rises in 2H22). We upgraded our view on Australian Equities this week to take advantage of the price weakness which emerged through January.

Read our asset allocation strategy - Navigating a Year of Cross Currents

Exhibit 1: S&P/ASX 300 consensus sector earnings growth vs 1 mth revision

	EPSg YoY 12mth Fwd	EPS Revisions 12mth Fwd
Utilities	9.0%	7.5%
Energy	34.5%	5.5%
Materials	-9.4%	3.1%
Healthcare	3.9%	1.6%
S&P/ASX 300	5.4%	1.3%
Comm. Svs	10.3%	0.6%
A-REIT	10.7%	0.3%
Financials	6.2%	-0.1%
Cons Discr	19.8%	-0.2%
Cons Staples	4.7%	-0.6%
Industrials	111.8%	-1.7%
IT	20.7%	-1.9%

Source: Refinitiv, Wilsons

Looking through the lens of the Wilsons Australian Equity Focus List, we would highlight the following companies as having upside share price risk through results season. BHP Group (BHP), HealthCo (HWC), James Hardie (JHX), News Corp (NWS), Seven Group (SVW), SEEK (SEK), Santos (STO) and Silk Laser (SLA).

What the Market is Expecting on Earnings

The good news is that 2022 earnings estimates have so far held up despite the emergence of Omicron in December, with small EPS upgrades on both a 1 and 3-month view across the S&P/ASX 300. Much of this is due to both energy and materials upgrades offsetting downward revisions for industrials as the recovery is pushed back in the more consumer-facing sectors.

This leaves earnings growth at 14.8% for FY22E and 5.7% for FY23E. Arguably there is some risk of slippage of earnings growth from FY22E into FY23E given the shadow lockdowns will still be with us through the reporting season.

Global growth-related names still outstrip domestic names from an earnings growth perspective in FY22E, but this is expected to significantly close in FY23E as domestic companies more fully participate in the recovery (companies like IAG (IAG), QANTAS (QAN), and Transurban (TCL).

Sector Level Earnings Expectations

Industrials, energy, and technology sectors rank highest in terms of earnings growth for the next 12 months. Technology is particularly interesting given the global sell-off in many technology names over the previous three months. Over the course of January, 6 of 11 sectors saw consensus earnings upgrades.

Sector laggard materials has the potential to see significant upgrades over the coming months if commodity prices remain buoyant. EPS estimates could be upgraded by >70% for FY22E and FY23E vs current market estimates if spot prices hold.

The market, in our view, is too aggressive around commodity prices reverting to long-term levels. The lower A$/US$ is also beneficial for material sector earnings and could be a source of potential upgrades if the currency remains in the low 70s vs market expectations in the mid-70s.

Dividends

Despite earnings being ahead of pre-COVID levels, dividends lag on both an absolute basis and on a payout level. The banks are major culprits here with lower earnings, more shares on issue, and payout ratios which are likely to sit 5-10% below pre-COVID levels.

With buoyant commodity prices the materials and energy sectors could well surprise to the upside on dividends through February.

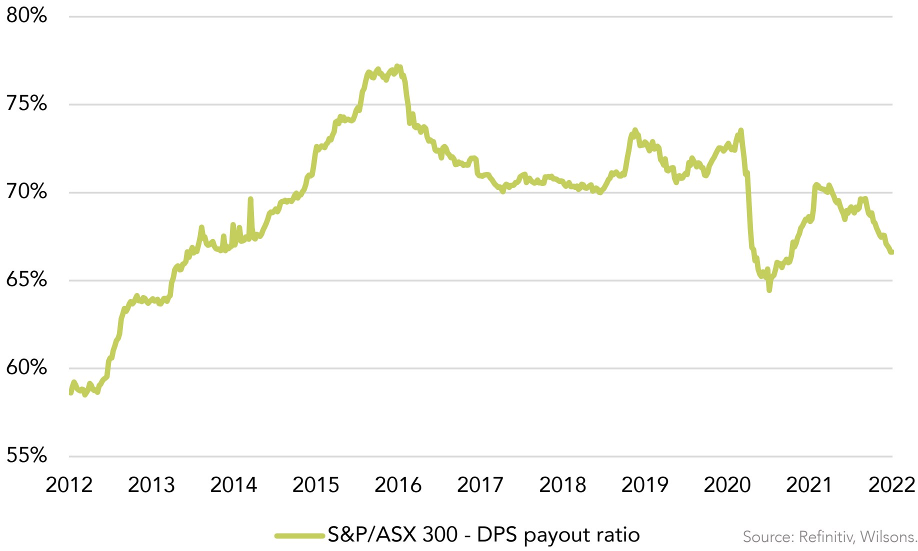
In terms of dividends, we expect BHP Group (BHP, Focus List member) and Rio Tinto (RIO) to both pay out ~US$8bn of dividends for the Dec-half. There is potential for BHP to split the cash return between dividends and a share buy-back post the successful unification vote in Jan-22.

For BHP, the payout ratio could be >85% (75% payout ratio average over the past eight reporting periods) as we expect all free cash flow (FCF) to be returned to shareholders. A lower net debt target could also lift the payout ratio, given it is possible BHP is in a net cash position by mid-2022.

RIO is also set to surprise with final dividend equating to an 80% payout ratio or ~$US5.10 per share. The market is currently expecting ~ $US4.80 per share. A buy-back is a low probability in our view, as it would take Chinalco's take in RIO over the 14.99% threshold agreed with the government in 2008.

Energy companies Santos (STO, Focus List member) and Woodside (WPL) face contrasting dividend challenges. Both companies could potentially flag a change to their dividend policy at the February results.

Exhibit 2: Dividend payout ratios remain well below pre-COVID levels



Source: Refinitiv, Wilsons.

Both STO and WPL delivered much better than expected revenue outcomes in 2021 due to volumes and pricing outcomes. Frustratingly, both companies have significantly underperformed global energy peers during 2021. We see part of the explanation is being a lack of FCF generation as STO and WPL both pursue growth. The market does not seem willing to reward energy companies for production growth. In contrast, the dividend yield of BHP/RIO is ~10% at spot prices vs STO at ~4% and WPL ~8%.

Post-merger we see the potential for STO to lift the dividend payout from 10-30% to 50% of FCF. The balance sheet is de-gearing rapidly, removing credit rating restrictions on the dividend. Part of any change in payout ratio would also be dependent on STO selling down assets to help fund growth. A higher payout ratio, allowing benefits of higher commodity prices to flow to shareholders whilst still investing in major growth projects would re-rate the STO share price in our view.

WPL in contrast may need to reduce its 80% dividend payout ratio to help fund growth ($5bn by 2030).

Is Earnings Season the Main Game in February?

Reporting season may not be the main game for the Australian market in February. The hawkish pivot from central banks, the push back of recovery (Omicron), and rising geopolitical tensions in Europe have had an impact in rattling equity markets across January 2022. These issues are unlikely to be resolved over February.

The 7% pullback in the Australian market during January may have taken some of the sting out of what has the potential to be a tough results period in terms of both reported numbers and the market backdrop. Companies with large negative surprises are again expected to be dealt with harshly by the market.

The US results season provides some clues to how investors will navigate the domestic reporting season. To date, the US reporting season is delivering at the lower level of earnings beats vs prior years (slowing recovery in earnings, Omicron impact). CY22 earnings expectations are largely holding, suggesting the market views the Omicron impact as a temporary shock. US stocks that are outperforming ahead of results are tending to do best, both on result day and in the days post results. Companies viewed as COVID winners need upgrades to outperform. The 'free-pass' they were given in recent results seasons appears to no longer be current.

On the next page we share our preview comments on the Focus List companies reporting in February.

Exhibit 3: Focus List reporting season dates and preview comments

Potential upside surprises

Company	Ticker	Date	Event	Detail
Communication Services				
News Corp	NWS	03-Feb-22	1Q22 Results	Earnings should again be benefit from cyclical recovery. Look for news flow on further implication, potential FOXTEL divestment and update on on-market buyback.
Telstra	TLS	11-Feb-22	1H22 Results	Earnings should be uneventful, benefiting from more rational mobile markets. FY22 guidance of EBITDA $7.0-7.3bn and FY23 $7.5-8.0bn should be reiterated. Look for update on strategic initiatives - including potential divestment of FOXTEL assets.
Seek	SEK	15-Feb-22	1H22 Results	See upside risk to earnings given SME focus, listing volumes, and yield based pricing strategy.
Consumer Discretionary				
Silk Laser Australia	SLA	TBA	1H22 Results	Update on sales rates following COVID impacted summer. No guidance for FY22 outside of 4-8 clinic openings (4 already done in 1H).
Energy				
Santos	STO	16-Feb-22	FY21 Results	First result post STO/OSH merger. Look comments around asset divestments, dividend payout ratio, and future capital commitments. We think STO needs to prioritise FCF over production growth.
Financials				
Pinnacle Investment Management	PIN	03-Feb-22	1H22 Results	With earnings numbers largely known the Focus will be new growth initiatives, including the integration of recently acquired Five V.
Westpac	WBC	07-Feb-22	1Q22 Update	Pillar 3 update and trading update. Looking for evidence that WBC market share losses have slowed and better costs control.
ANZ	ANZ	07-Feb-22	1Q22 Trading Update	Key issues: 1) Looking for evidence of recapturing home lending market share, 2) NIM.
Macquarie Group	MQG	08-Feb-22	2022 Operational Briefing	No guidance for FY22 at this stage. Market looking for +24% earnings growth for FY22E. We think MQG will withhold guidance until closer to March 22. Market volatility and strong energy prices are likely to provide a tails wind for earnings.
NAB	NAB	10-Feb-22	1Q22 Trading Update	Key issues: 1) Revenue momentum, 2) NIM.
IAG	IAG	11-Feb-22	1H22 Results	Key issues: 1) Pathway from current margin guidance of 10-12% FY22 to 15-17% medium term, 2) Intermediated business performance, noting IAG as looking for +$250m profit improvement medium-term, 3) capital management given IAG's $1.2bn BI provision (more likely FY22 result).
Judo Capital	JDO	22-Feb-22	1H22 Results	Maiden earnings results. Expect JDO to maintain $6bn loan book guidance. This is dependent on a stronger pick up in 2H vols. Update on growth initiatives is also likely.
Healthcare				
CSL	CSL	16-Feb-22	1H22 Results	Expect FY22E guidance of $2,150-2,250 to be reiterated. 1H22 should be well supported via by strong flu-driven sales.
Telix Pharmaceuticals	TLX	23-Feb-22	1H22 Results	Look for updates on US reimbursement approval, sales ramp up, and clinical trials post the January 2022 $A200m capital raising.
Industrials				
Seven Group Holdings	SVW	16-Feb-22	FY21 Results	AGM comments in 4Q21 suggested Westrac and Coates businesses were performing well. We suspect there has some slippage with Coates due to COVID lockdowns. Look for strategic updates, including capital management (post BLD inclusion) and M&A opportunities. At 10x PER, SVW is not trading on a demanding multiple.
Qantas Airways	QAN	24-Feb-22	1H22 Results	Guidance is for EBITDA loss of $250-300m. Recovery is very much in hands of both domestic and international border reopening. FY23 earnings can still be ahead of pre-COVID levels given structural costs that have been removed. Look for update on $2bn CAPEX plans for aircraft.
Information Technology				
EML Payments	EML	14-Feb-22	1H22 Results	FY22 revenue guidance of $230-250m, EBITDA of $58-65m range expected to be tightened. Update on Irish regulatory investigation.
Block	SQ2	24-Feb-22	4Q21 Results	First result post Afterpay being incorporated into Block (formerly known as Square). Market looking for a revenue growth acceleration 4Q vs 3Q, taking FY21 revenue growth to +85% YoY.
Materials				
James Hardie	JHX	07-Feb-22	3Q22 Results	JHX upgraded FY22 guidance in January to US$605-625m (+100% yoy). First time FY23 guidance to be issued, market currently at +25%. Update on CEO, following unexpected departure in January.
Northern Star	NST	08-Feb-22	1H22 Results	Post a soft 4Q, the focus will be on dividend (market looking for 10cps) and strategic outlook, including potential for further M&A in North America.
BHP	BHP	15-Feb-22	1H22 Results	Key focus will be on the dividend, we see upside risk vs market given CF generation in 1H. We look for 85% payout ratio vs 75% average over the last 4 years. Cash dividend could be split between common dividend and an off-market fully franked buyback.
OZ Minerals	OZL	21-Feb-22	1H22 Results	Dividend the focus post the recent soft 4Q result - higher costs, lowered production guidance, and higher working capital. Look for update on strategic expansions and comments around funding. Equity raising post 4Q downgrade is now more likely.
Real Estate				
Goodman Group	GMG	17-Feb-22	1H22 Results	GMG upgraded FY22 guidance to >15% EPSg in Nov. US peer Prologis in January also upgraded its FY outlook given strong demand outlook.
Healthco Healthcare and Wellness REIT	HCW	18-Feb-22	1H22 Results	FY22 guidance was upgrade in October following deployment of capital into new asset. Look for further update on how balance sheet deployment.

Source: Refinitiv, Wilsons.

Wilsons Australian Equity Focus List: Pre-Reporting Season Tune Up

Ahead of the reporting season we make several changes to the Focus List. In short, we add to both cyclical exposures and high growth names. We are funding this lower weighting to Insurance Australia Group (IAG) and Telstra (TLS).

Banks

We have lifted our core bank weighting by 1.5% percentage points to leave the Focus List at 0.96x vs the major banks.

Our upgraded sector view on the banks is based on the potential for improved revenue momentum in a rising rate environment. This should help take some pressure off the costs which have been a material drag on earnings sector. We believe this should be become evident as we move through 2022. We have added to existing positions in ANZ (ANZ), NAB (NAB), and Westpac (WBC).

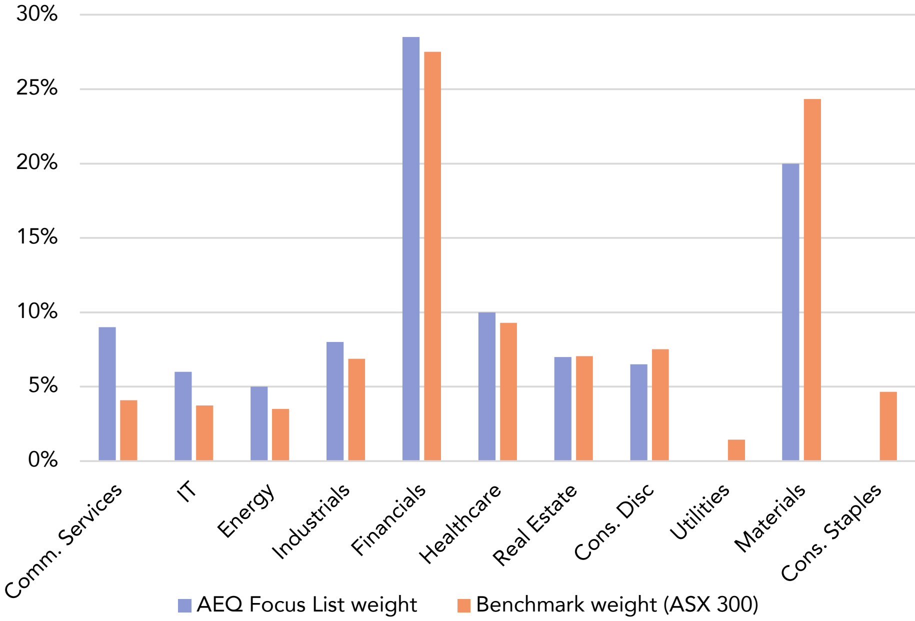
Diversified Financials

Staying in financials, we have added Pinnacle Investment Management Group (PNI) at a 2% weight. The sell-off in high growth, high multiple companies has been savage (faster than what we saw in the 2001 technology sell-off).

PNI has been caught up in this sell-off, with the share price down almost 50% from its 4Q21 high. Whilst we cannot be certain this growth/value rotation in equity markets is over, we do need to acknowledge the price reaction. We anticipate adding more exposure to (potentially) oversold high growth companies during the 1Q22.

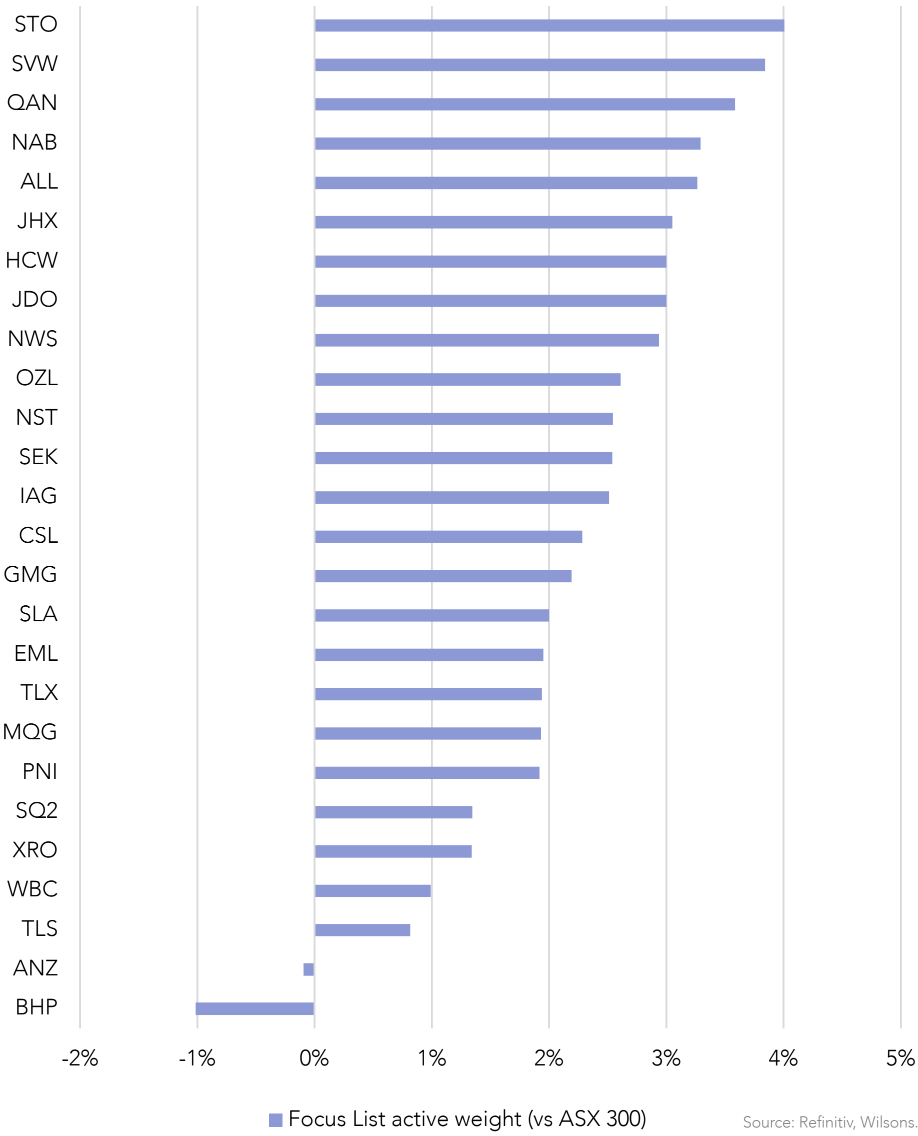
We see PNI as a high growth investment manager with a funds under management (FUM) acquisition strategy across multiple asset classes and geographies. Whilst equity market volatility has the potential to impact FUM flows -a clear negative for the share price, particularly in growth-focused equity funds like Hyperion - ultimately we think the concerns will be short-lived. We also point out that PNI is becoming more of a multi-asset manager vs equities-only house, with fund strategies now across credit, loans, and private equity.

Exhibit 4: Focus List sector weighting vs the market



Source: Refinitiv, Wilsons.

Exhibit 5: Focus List active weights post changes



Source: Refinitiv, Wilsons.

From a valuation perspective, market earnings currently imply a 3-year EPS CAGR of 20%, almost x3 higher than the forecast growth from the S&P/ASX 300.

The collapse in the share price has halved PNI's PE relative to the market, which now stands at 1.3x, a 25% discount to 5-year historical discount, and approaching the March 2020 valuation trough.

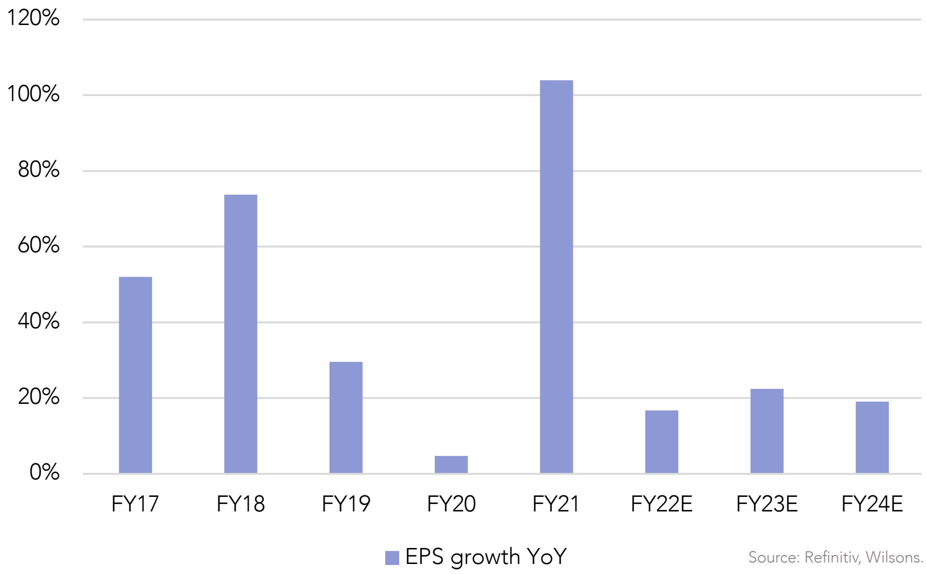
Insurance

We have lowered our weighting to IAG (IAG) from 5% to 3%. The Focus list is now market weight insurance. IAG's return to more normalised earnings is taking longer than initially hoped. We remain optimistic that improved earnings performance can be displayed. In addition, a positive resolution on the business interruption insurance issue can potentially fund a return of capital (something IAG is now communicating about). With a resolution of these issues, perhaps not for another 6 months, holding such a large active position in IAG we felt was too aggressive.

Communication Services

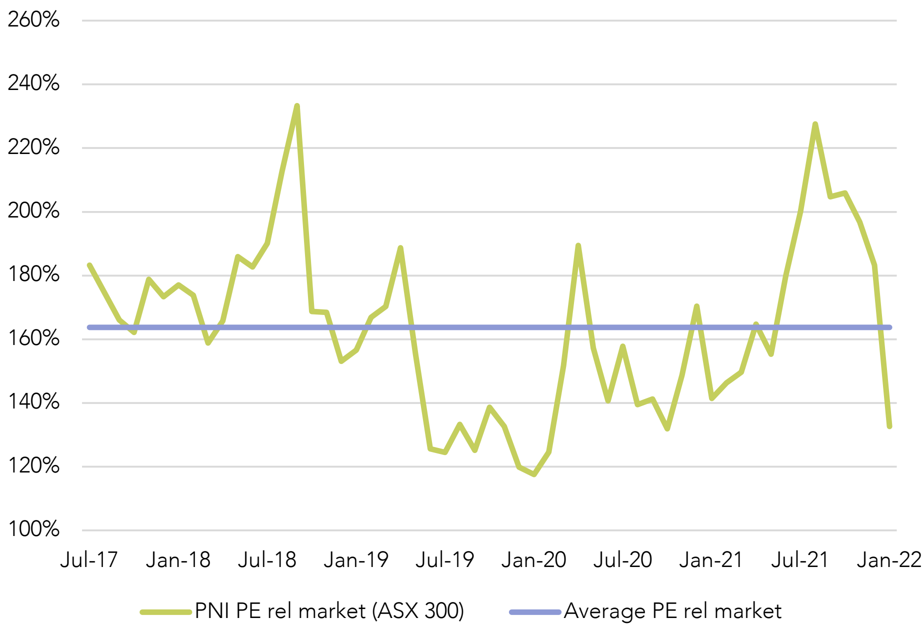
We have reduced our weight in Telstra (TLS) from 4.5% to 3%. This follows a period of outperformance vs the market and closing of the valuation gap. While further strategic repositioning is likely - including a potential divestment of FOXTEL (better played via Focus List member News Corporation (NWS)) - the earnings improvement story in mobile is now better understood across the market and reflected in the share price.

Exhibit 6: PNI earnings doubled in 2021. 3yr EPS CAGR of 20% is x3 higher than the market



Source: Refinitiv, Wilsons.

Exhibit 7: Whilst PNI's PE rel is now at a 25% discount its historical average



Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

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

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- HealthCo Healthcare and Wellness REIT (HCW.ASX) - Co-Lead Manager in the September 2021 Initial Public Offering
- Judo Capital Holdings Ltd (JDO.ASX) - Co-Lead Manager in the October 2021 Initial Public Offering
- Pinnacle Investment Management Group Limited (PNI.ASX) - Joint Lead Manager and Underwriter to the November 2021 Institutional Placement; Underwriter in the September 2021 and March 2021 Dividend Reinvestment Plans; and Joint Lead Manager in the July 2018 placement
- SILK Laser Australia Limited (SLA.ASX) - Joint Lead Manager in the June 2021 Institutional placement; and Joint Lead Manager and Underwriter in the November 2020 initial public offering
- Telix Pharmaceuticals Limited (TLX.ASX) - Lead Manager to the Telix Pharmaceuticals Limited January 2022 Institutional Placement and SPP; Co-Manager to the Telix Pharmaceuticals Limited July 2019 Placement

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