WILSONS

Positioning for the Caged Up Consumer

Our weekly view on Australian equities.

09 September 2021

The Reopening Theme Dominates

As Australia continues to edge closer to vaccination targets of +70% and +80% the prospect of a sharp rebound in activity levels for many service-oriented businesses improves. The reopening theme is likely to dominate investor interest into the end of 2021.

Likely to be led by NSW, with the potential loosening of restrictions as soon as mid-October 2021, restrictions are likely to ease gradually over a number of months into 2022. This provides some longevity around the reopening theme.

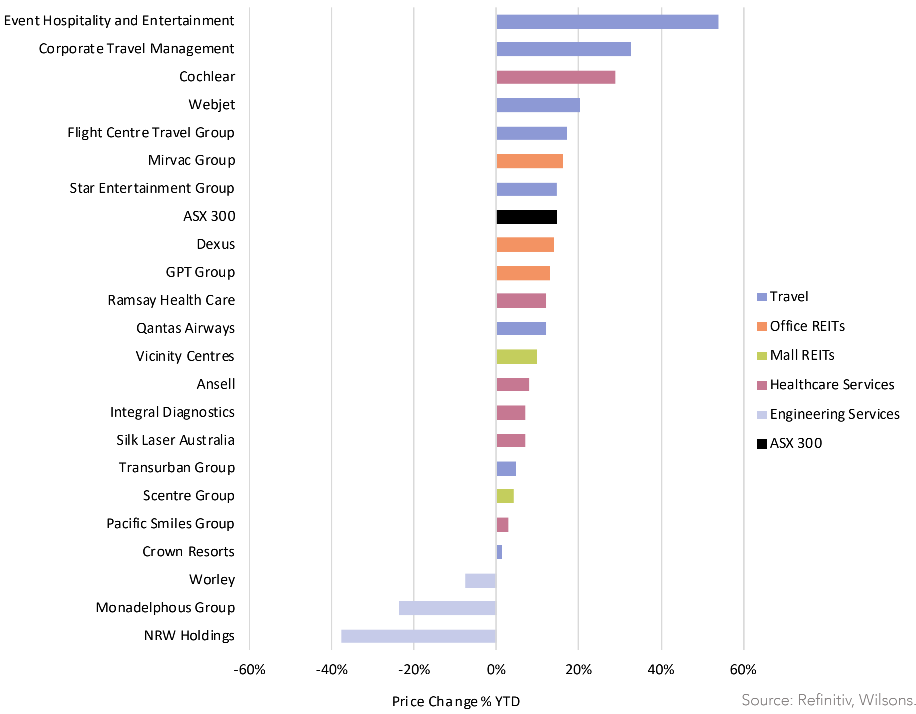
We think investors should be positioned for the reopening theme. Our preference is to be exposed to the domestic service-based reopeners in the sectors where we have greater confidence around both the timing and the level of pent-up demand. If positive structural changes to the industry or company have taken place over the COVID period, that only adds to the appeal.

In this context, we have increased the exposure within the Wilsons Australian Equity Focus List to the domestic reopening theme. The Focus List was already overweight cyclicals to a tune of ~60%, given our long-held views around the 'vaccine lighthouse' that would power the corporate earnings recovery. We think the prospect for caged up consumers to emerge in the coming months warrants a reweighting within the Focus List. We now have almost 20% of the Focus List in domestic reopening beneficiaries.

Read our note on Unleashing the Caged Up Consumer

In our view, the market is currently too aggressive in discounting the current state of lockdowns and domestic broader restrictions. Both QANTAS (QAN) and Silk Laser Australia (SLA) have been added to the Focus List. Both companies are significantly disrupted at present and can speak to prospects of strong levels of pent-up demand. Transurban (TCL) and Worley (WOR) have been removed.

Exhibit 1: The majority of reopening stocks have underperformed the market YTD



Source: Refinitiv, Wilsons.

We explore the earnings leverage across a range of companies that are currently impacted by the domestic lockdowns and provide our thoughts as to where investors should be positioned.

Which Companies offer the Greatest Rebound Potential

The reopening theme can be split into five different sub-themes:

- Travel services
- Healthcare services
- Office REITs
- Mall REITs
- Engineering services

The majority of these stocks have underperformed the S&P/ASX 300 year-to-date (YTD).

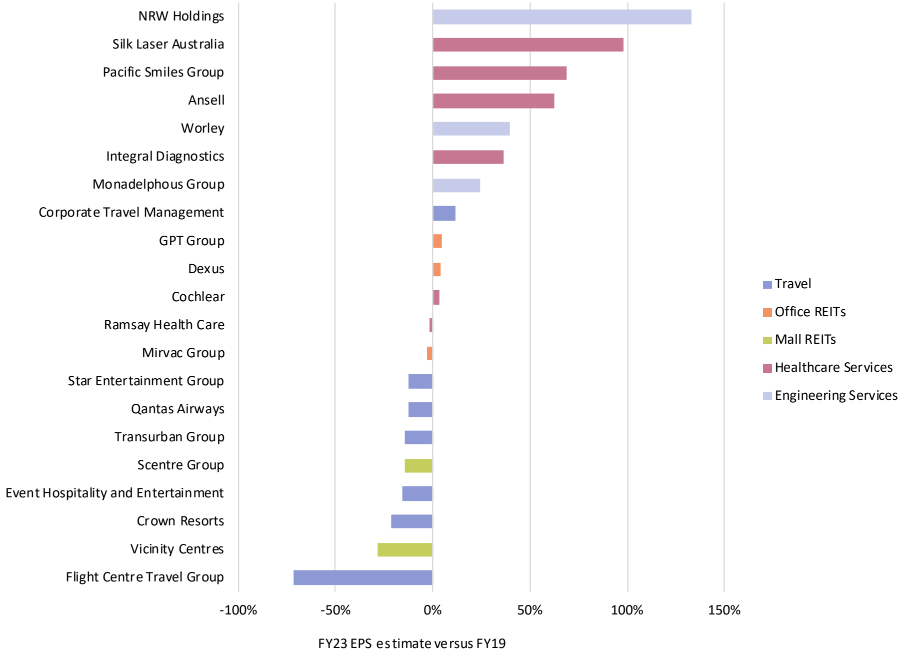
Among these themes, engineering services have performed the worst YTD. As a result of labour shortages, margins have been squeezed and stock prices have suffered. NRW Holdings (NWH) and Monadelphous (MND) have plummeted, but we believe these could be good opportunities once borders reopen – especially in WA. There is, however, still uncertainty around the WA border opening (the WA-QLD border being key for labour mobility).

In general, REITS have also underperformed, except for the housing-exposed Mirvac (MGR). A lack of shopping at malls and office visits has delayed the anticipated recovery for these stocks. A domestic reopening should support shopping mall REITs like Vicinity Centres (VCX) and Scentre Group (SCG). Office REITs like Dexus and GPT Group (GPT) face the structural battle of potentially lower growth rates as flexible working becomes more widespread. The Focus List does not include these large-cap REITs as we prefer small-cap REITs for their longer-term structural growth potential.

Read Alternative A-REITS: From Little Things, Big Things Grow

As a result of Delta lockdown restrictions, travel service stocks have underperformed the S&P/ASX 300 since June. However, these stocks have performed better in recent weeks, as the prospect of reopening has been somewhat clearer.

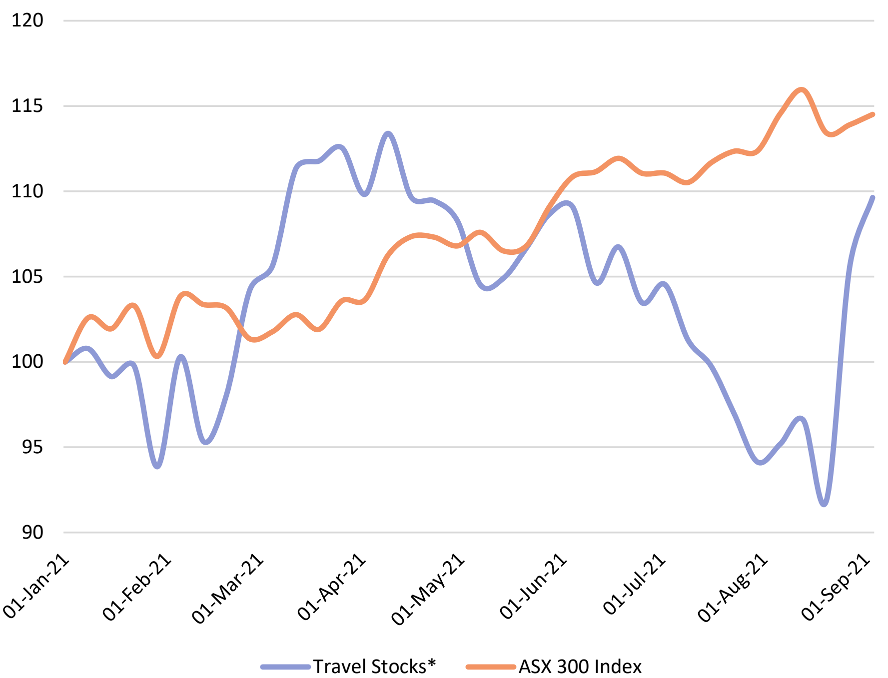
Exhibit 2: Travel stocks are expected to have lower EPS in FY23 than pre-pandemic (FY19)



*Silk Laser uses FY23/FY21

Source: Refinitiv, Wilsons.

Exhibit 3: Travel service stocks have underperformed the market so far this year



*Equally weighted index of FLT, WEB, QAN, CWN, SGR

Source: Refinitiv, Wilsons. Rebased to 100 1 Jan 2021.

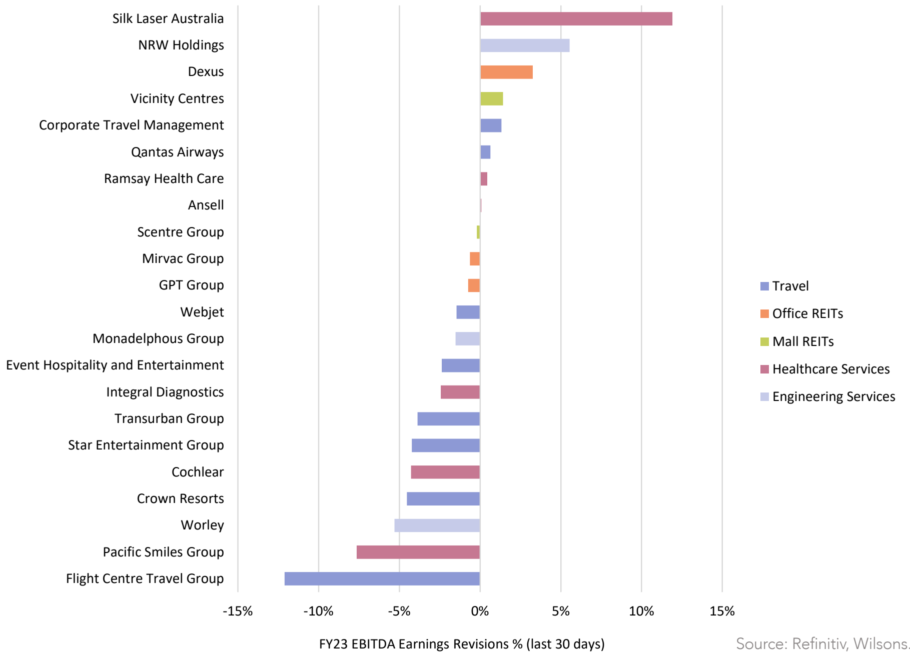
Despite forecasts of earnings recovery in the next two years, absolute earnings for travel service stocks in FY23E remain below pre-COVID-19 levels. This was exacerbated at the earnings per share (EPS) level given the equity issuance this group of stocks required. Additionally, multiples in FY23 tend to be undemanding.

There is still a high degree of uncertainty regarding an international reopening relative to domestic. Consequently, domestic travel recovery stocks may have more short-term upside. QANTAS (QAN), which is more leveraged to the domestic reopening, has seen earnings (EBITDA) upgrades for FY23E over the past month; we expect this trend to continue as the path towards a domestic reopening becomes less uncertain.

We believe the uncertainty surrounding international travel is detrimental to Flight Centre (FLT) and the Casinos (CWN and SGR). Long-term, these stocks should recover once international borders reopen, but it may be into early 2022 before international travel at scale can return to Australia.

Over the past two months, healthcare services stocks (ex-Cochlear (COH)) have underperformed. The dentist or laser hair removal may not be on the top of everyone's list once lockdowns end in NSW and VIC. Still, we anticipate that these services will be in high demand since consumers have not been able to access them for an extended period. These stocks do not require domestic borders to reopen, just localised lockdowns to lift. We anticipate this group of stocks could see earnings recover quickly once reopening is underway.

Exhibit 4: This month, domestic reopeners have seen more FY23E earnings upgrades than international



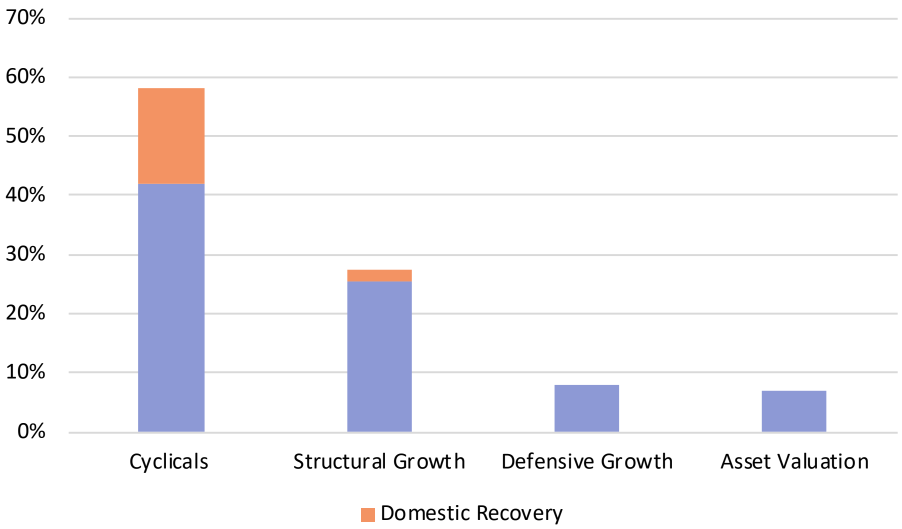
Source: Refinitiv, Wilsons.

Exhibit 5: Reopening beneficiaries and metrics

Company	Market Cap (A$b)	Price/ Earnings FY23	Price/ Earnings FY24E	EPSg FY23E	EPSg FY24E	EPS FY22E	EPS FY23E	EPS FY24E
Travel								
Flight Centre Travel Group Ltd	3.7	27.6	16.4	N/A	68%	-0.67	0.67	1.13
Crown Resorts Ltd	6.7	23.0	18.9	930%	22%	0.04	0.42	0.52
Star Entertainment Group	4.0	20.5	16.8	408%	23%	0.04	0.21	0.25
Transurban Group	39.6	87.9	67.6	242%	30%	0.05	0.16	0.21
Event Hospitality and Entertainment Ltd	2.4	26.8	22.9	N/A	17%	0.00	0.55	0.64
Webjet Ltd	2.3	28.6	20.5	N/A	39%	-0.05	0.21	0.30
Qantas Airways Ltd	10.3	11.1	7.8	N/A	42%	-0.31	0.49	0.70
Corporate Travel Management Ltd	3.2	24.1	20.7	124%	16%	0.43	0.97	1.12
Office REITs								
GPT Group	9.8	14.9	14.0	4%	10%	0.33	0.34	0.34
Mirvac Group	12.2	18.5	18.0	11%	3%	0.15	0.17	0.17
Dexus	11.6	15.7	14.6	3%	7%	0.66	0.68	0.73
Mall REITs								
Scentre Group	15.2	13.4	12.8	7%	5%	0.20	0.22	0.23
Vicinity Centres	8.1	13.8	13.3	19%	3%	0.11	0.13	0.13
Healthcare Services								
Pacific Smiles Group Ltd	0.4	26.3	21.8	184%	21%	0.04	0.10	0.12
Cochlear Ltd	16.1	49.2	43.5	16%	13%	4.28	4.95	5.60
Integral Diagnostics Ltd	0.9	21.4	20.0	18%	7%	0.18	0.22	0.23
Ansell Ltd	4.8	15.6	14.9	-2%	5%	1.82	1.78	1.86
Ramsay Health Care Ltd	16.1	24.8	23.0	25%	8%	2.26	2.81	3.03
Silk Laser Australia Ltd	0.2	16.8	15.2	55%	11%	0.15	0.23	0.25
Engineering Services								
Worley Ltd	5.6	13.3	12.1	18%	10%	0.68	0.80	0.88
Monadelphous Group Ltd	1.0	15.4	14.7	29%	5%	0.52	0.67	0.70
NRW Holdings Ltd	0.8	7.4	7.3	14%	1%	0.22	0.24	0.25

Source: Refinitiv, Wilsons.

Exhibit 6: Focus List themes; 55% exposed to cyclical companies of which 20% are direct beneficiaries of domestic reopening



Source: Refinitiv, Wilsons. Domestic Recovery includes: IAG, QAN, SVW, SYD, SLA.

Reweighting the Focus List

We outline below our summary investment thesis at a stock level for changes we are making. We believe the domestic reopening thematic has a number of quarters of runway ahead once the reopening gets underway – likely in mid-late October 2021.

Importantly, our new positions in both QAN and SLA have multiple contributing aspects that do not just hang on domestic reopening. We think this is an important distinction, particularly in the context of risk-adjusted returns. If there is one thing COVID has taught investors, it is that recovery is not always assured. Having a number of dimensions to the investment case can help mitigate the risk of slippage in a scenario where reopening is pushed back.

Post the changes we have made, Focus List companies are expected to show EPS growth of +45% in FY22E – well ahead of the S&P/ASX 300 at 20% (using Refinitiv estimates). Our cyclical exposures have increased and now represent around 55% of the Focus List up from 50%. We now have a much greater exposure to near-term domestic reopen beneficiaries. A measure of the Focus List's quality, return on equity (ROE) is expected to lift from 13% in FY22E to over 15% in FY23E as profitability improves across a number of companies.

QANTAS (QAN) 4% Weight

- QAN is currently loss-making with both the domestic and international business effectively shut. Losses in the current half are likely to be in the range of $A0.5bn to $A1.0bn. QAN has access to $A3.5bn of liquidity if needed, implying a buffer for equity holders should domestic travel restrictions remain in place well into 2022. Earnings are likely to rebound strongly once domestic travel restrictions are eased. QAN does not need the International business to open to be profitable.
- We see three aspects to the investment case with QAN;
  - **Domestic business reopens beginning in 4Q21.** The domestic business could run at 110% of capacity through 2022/23 as pent-up domestic demand takes hold. We note in Apr/May 2021 pre-COVID Delta lockdowns, QAN domestic was operating at 110% of capacity;
  - **International.** At some stage during 2022 international travel is likely to resume at scale. Australia's multicultural makeup and iconic holiday destinations suggest a return to profitability with International will not take long. QAN is likely to have higher market share vs pre-COVID in international.
  - **Group profitability post-COVID should be materially higher than pre-COVID.** Virgin Australia's withdrawal of capacity domestically under new private equity ownership combined with structural cost savings QAN has put in place could result in sustainable earnings for QAN being almost $A1bn higher in 2023/24.
- QAN trades on PER ~10x FY23E market estimates. A 60% discount to the market ex-financials, which is broadly in line with its historical average. Earnings are heavily depressed, perhaps in the order of +30% in FY23E. There is also inherent value in the QAN loyalty business which the current share price does not reflect. In short, QAN provides both operational and financial leverage to the reopening thematic. Medium-term, a higher potential cash generation vs pre-COVID suggests a pathway to reduce the 25% increase in shares on issue that QAN required during COVID.

SILK Laser Australia (SLA)
2% Weight

- SLA is the third-largest operator offering non-surgical aesthetic products and services in Australia and New Zealand. The underlying drivers of the business are predominantly around women wanting to look and feel great about themselves.
  Advancements in technology driving new treatment modalities add a layer of GDP+ style earnings growth. SLA offers a strong roll-up story as fragmented industry and technology (capital intensive) increasingly benefit scale players.
- Since listing in late 2020 (share price $3.45), the business has made a strategic acquisition (given size), purchasing peer operator Australian Skin Clinics (ASC) for $52m and raising $20m of new equity capital. ASC almost doubles the size of SLA from 61 to 117 clinics. SLA believes the acquisition could be accretive to EPS by +20% on an FY basis.
- As a domestic service business, COVID lockdowns have impacted VIC and NSW store clinics reducing profitability. Lockdowns and some investor caution around the ASC acquisition/capital raising have
  resulted in SLA underperforming the market since IPO. With strong reopening potential, acquisition synergies and pathway to grow the business both organically and inorganically to 150+ clinics, we are attracted to what could be high growth, high return on capital business (mid-teens plus ROE).

Read our note on
Silk Laser Australia

Worley (WOR) Removed

We are worried that we have 'thesis drift' in WOR. Whilst the oil price has rallied strongly since we added WOR in November 2020, the rate of improvement in WOR's revenue outlook has been slower than expected.

A wave of global M&A within its key clients suggests further delays and the potential for margin pressure could also emerge as part of the narrative over the next 6-12mths. We elect to recycle capital out of WOR and into domestic reopening beneficiaries where we have a higher conviction around the reopening thematic. Prior weighting 4%.

Santos (STO) lifted from 4% to 5%

We remain bullish on the energy story as economies reopen and the industry suffers from years of underinvestment. An oil price squeeze underpinning material rally in the oil price is not out of the question during 2022 in our view.

Energy stocks have underperformed over the past two months, despite value-accretive M&A occurring. We think the STO + Oil Search (OSH) merger proposal makes strategic sense in a world where scale is your best line of defence against ever-tightening ESG metrics. STO/OSH merger in contrast to Woodside Petroleum (WPL) merger with BHP's (BHP) petroleum assets has the prospect to accelerate production growth.

Transurban (TCL) Removed

We see TCL as trading around fair value in the mid $14s. Domestic lockdowns have not helped, particularly given key toll roads are in NSW and VIC, which imply reopening tailwinds. We see stronger leverage to the domestic reopening theme in other names.

In the short-term, TCL looks well placed to potentially acquire a further 50% interest in the WestConnex (NSW) toll road – which could be valued at $A10-$A13bn. This would necessitate an equity raising.

Given the nature of WCX - which is not expected to reach the full run-rate of cash generation until 2025E - we estimate the potential acquistion of WCX would be distribution per unit (DPU) dilutive over FY22E-FY24E. This has the potential to cause indigestion issues for the TCL share price. Prior weighting 4%.

James Hardie (JHX) lifted from 3% to 4%

JHX continues to execute well. We believe earnings risks remain to the upside through FY22E driven by JHX's margin leverage to increased volumes.

Recent US home builder commentary during 2Q was positive, highlighting backlogs remaining across the industry. US housing starts are running at +28% YoY in June, whilst permits are running at +22%, suggesting buoyant housing conditions are likely to remain in place for a while yet.

With the prospect of mid-teens EPS growth in FY22E against a 27x price to earnings ratio (PER), a discount to market ex-financials at 30x. Historically JHX has traded at a premium to the market.

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Recommendation structure and other definitions

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

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All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

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Wilsons contact

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au