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Ausbil Reporting Season Wrap FY21

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Highlights

- Australian resources deliver biggest profits ever.
- Banks setting up to deliver record capital management in FY21, with banks and insurers showing potential for further capital release.
- Inflation impacts on costs, wages and inputs still not noted as a major concern.
- While companies were hesitant to guide on FY22 given lockdowns, a lead indicator for sustainable earnings growth was the bullish investment plans from management for beyond COVID as the economy normalises. We see this as driving potential future earnings growth surprise.
- Balance sheets were generally strong and capable of supporting an expansion in investment following COVID-19.
- Cyclicals continue to perform, with strong earnings outlooks for FY22, particularly from late calendar 2021.
- Quality growth is also offering a strong earnings rebound into FY22 and FY23.
- The market is still supporting the reopening trade and looking through the noise of lockdowns.
- EPS growth (EPSg) for FY21 of circa 27% was achieved, with expectations for ~17% EPSg for FY22.
- 25 of 32 functional GICS sectors are expected to deliver positive EPS growth in FY22 representing 80% of the market by market cap.

Context

As the pandemic drags on, FY21 reporting season represents the first full-year results announcement since COVID-19 began. During what is an historic epoch, this reporting season was expected to demonstrate the extent to which unprecedented stimulus had helped most Australian companies return to a semblance of normality, with a rebound in earnings expected to deliver on the huge support provided by governments in 2020.

If HY21 was the COVID-rebound reporting season, FY21 was to be the consolidation of a new EPS growth path, the start of a number of years of above average earnings growth fuelled by a steady return towards normality, on vaccination, recapitalised balance sheets, and with the tailwind of government and central bank stimulus.

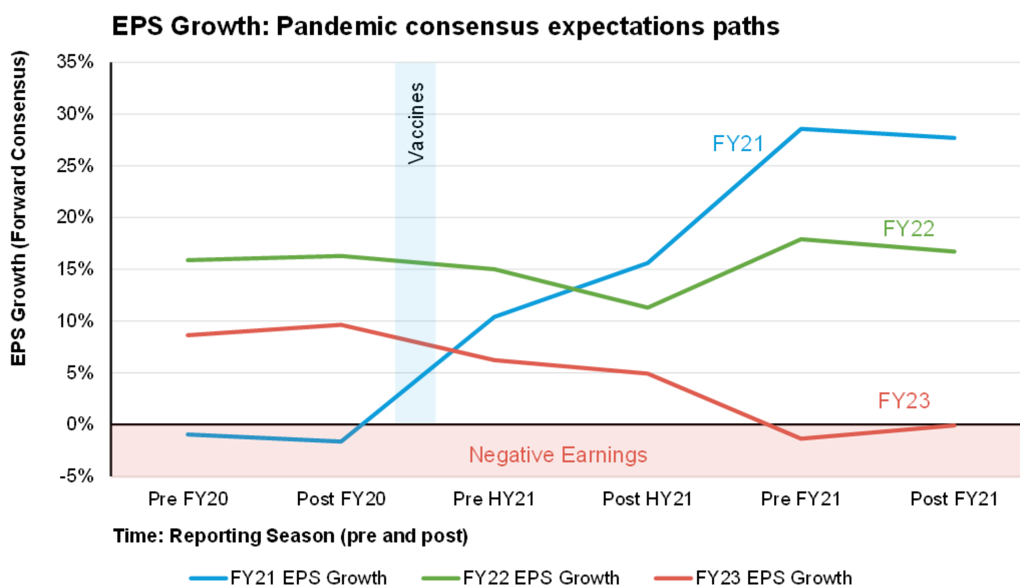
FY21 reporting season was delivered with most of the country in lockdown, including Australia's largest economic unit, New South Wales. Australian government plans to pass 70% vaccination targets and achieve 80% have rocketed in recent weeks with a groundswell of vaccination activity across the country, and a general desire across the nation for these levels to be achieved. While the media makes much noise about a minority of oppositionists to vaccines, our observation is that a stoical majority of Australians are doing what they can to help governments achieve the targets. To this end, the numbers are showing success with 38.4% of adults now fully vaccinated and 63.2% already on one dose, only 8-weeks ago these numbers were 10% and 32% respectively (Department of Health, NSW as at 6 September 2021). This augers well for the re-opening of Australia's state economies in good time, and a resumption of cautionary but more normal activity as we head towards Christmas.

So how have Australia's listed companies fared in FY21, did the earnings growth transpire, and what are companies telling us about the year to come?

What does the market expect on FY22 earnings?

Reporting season closed with EPSg for 2021 at circa +27% in EPS (S&P/ASX 200), rebounding from a -17% EPS decline in the FY20 pandemic year. This was slightly shy of earnings expectation at their peak of around +29% (consensus) at the start of FY21 reporting season, as illustrated in Chart 1. Expectations are now tempering following reporting season, with FY22 consensus EPS growth expectations at around +16.7%, and FY23 expectations just negative at -0.1%.

Chart 1: Path of market earnings expectations



Source: Ausbil, FactSet

However, across the FY21 reporting season the expectations for FY23 firmed somewhat, bringing expected EPS growth back to around zero. This current outlook is highly impacted by the market's view on lockdowns and the path to vaccination targets. If these are achieved in good time, consensus is likely to move up significantly, assuming inflation remains benign and the economy continues on its expected growth path to trend.

Our view is that FY23 earnings expectations will turn to positive, with growth driven by a very strong post-Delta variant bounce-back, which will be evident in the final months of this calendar year, and will have duration into FY23.

While many companies avoided providing guidance for FY22 given the uncertainty around lockdowns, most companies were very optimistic for a strong recovery. Another lead indicator for future earnings was the bullishness in which companies described their operating outlook beyond the COVID-19 Delta strain. Insights gleaned from meetings across reporting season showed that management had a means and a willingness to invest in the future of their companies beyond the current COVID lockdowns, and in most cases, balance sheets were strong and capable of supporting such investment as the COVID risk subsides. Clearly, there is an element of the unknown with respect to when the economy might normalise in a post-COVID world, but given the rapid progress on vaccines, once the risks are lowered, we believe earnings growth is likely to surprise again.

EPS growth expectations across sectors

In term of EPS growth expectations across sectors, at the end of reporting season, the market seemed to be firming on more positive growth in cyclical sectors (steel, energy, chemicals and diversified metals & mining), with a blend of reopening exposures (hotels, restaurants & leisure), quality (general insurers and infrastructure trusts) and quality growth (in high-quality software and services and online services), as illustrated in Table 1. Across reporting season, the EPSg consensus outlook for FY22 fell 1.2% from +17.9% to +16.7%.

Table 1: 25 of 32 sectors expected to generate positive earnings in FY22

FY22 EPS Growth Consensus by Sector

Sector	EPS Growth: Before FY21 Reporting Season	EPS Growth: After FY21 Reporting Season	Change	Market Cap ($bn)
Software & Services	58.1%	106.0%	47.9%	73
Steel	16.0%	94.5%	78.5%	15
Energy	77.9%	80.4%	2.6%	49
Infrastructure Trusts	83.3%	61.0%	-22.2%	68
Hotels Restaurants & Leisure	80.6%	55.4%	-25.2%	66
General Insurance	55.6%	51.4%	-4.2%	63
Diversified Consumer Services	35.0%	32.8%	-2.2%	7
Chemicals	31.1%	32.3%	1.2%	12
Online Services	41.4%	28.7%	-12.7%	38
Agriculture	28.6%	24.9%	-3.7%	12
Diversified Metals & Mining	21.0%	21.2%	0.2%	176
Market	**17.9%**	**16.7%**	**-1.2%**	**2,110**
Capital Goods	18.1%	16.0%	-2.2%	22
Banks	14.5%	15.7%	1.1%	458
Other Metals & Mining	11.1%	14.1%	3.1%	104
Construction Materials	15.5%	11.7%	-3.8%	39
Media	8.3%	9.5%	1.2%	4
Commercial Services & Supplies	11.7%	8.9%	-2.8%	30
Diversified Financials	9.4%	7.8%	-1.5%	120
Real Estate Investment Trusts	10.3%	7.4%	-2.9%	139
Food Beverage & Tobacco	6.2%	5.4%	-0.9%	9
Life Insurance	1.6%	4.2%	2.7%	7
Food & Drug Retailing	-0.7%	4.0%	4.8%	92
Containers & Packaging	7.9%	3.9%	-4.0%	17
Gold	24.2%	1.9%	-22.3%	50
Automobile & Components	2.7%	0.2%	-2.5%	7
Pharmaceuticals & Biotechnology	-3.4%	-1.9%	1.5%	145
Real Estate	27.4%	-6.4%	-33.8%	8
Health Care Equipment & Services	-12.8%	-7.3%	5.5%	80
Telecommunication Services	8.3%	-7.8%	-16.1%	57
Utilities	5.5%	-9.9%	-15.4%	31
Retailing	-7.5%	-12.5%	-5.0%	88
Transport (Ex Infrastructure Trusts)	-185.1%	-105.5%	79.6%	23

Source: Ausbil, FactSet

Overall, the market is expecting positive growth in 25 of the 32 functional GICS sectors (or 80% of the market by market cap). Of these sectors, 11 are expected to generates EPSg over and above the market average, representing 28 percent of the S&P/ASX 200 market cap.

Key developments this reporting season

Metals and mining break records, fundamentals remain in place for FY22 earnings growth

Metals and mining had a record year, generating the largest dividend haul in history and some record results, including BHP generating $37bn in EBITDA, Rio Tinto generating $21bn and Fortescue Metals producing $16.4bn on the back of booming iron ore markets. Of note was the fact that BHP's result coincided with the announcement of a simplification plan, and a proposed end to dual listing. A fall in ore prices over the month saw prices pull back for iron ore exposed miners, however, this was off record highs at over $200/tonne, and the fundamentals of demand over supply remain supportive of positioning in quality iron ore names. Battery materials, electrification and energy storage metals continued to deliver to the long and developing renewable thematic. This saw strong performances across lithium names (Orecobre/Galaxy, Pilbara Minerals and IGO). Copper names also generated strong earnings (OZ Minerals, 29Metals, and of note the copper contributors in large diversified miners).

Banks have 'sailed' through COVID with strong lending and capital to return

Support for banks and the general populace through monetary and fiscal stimulus have softened the potential impact on bad and doubtful debts. This reporting season confirmed the excess capital position of banks. Banks that reported (CBA, Bendigo and Adelaide Bank, and NAB through their update) printed solid volumes and lower bad debts. In line with Ausbil's positioning and projections, a number of majors also announced buybacks (Suncorp, NAB, CBA, and ANZ), which saw support for the sector during reporting season, as can be seen in Table 2. There was further pressure on margins from lower interest rates, particularly for the retail banks. CEOs are largely optimistic that the economy will bounce back when restrictions and lockdowns are eased.

Insurers on the cusp of an upgrade cycle, potential for capital release

There are signs of an upgrade cycle emerging in insurance, with Suncorp and QBE Insurance materially beating earnings expectations (IAG pre-announced result) driven by better than forecast gross written premium growth. The cycle continues to remain 'hard' and is likely to continue to be so, given a wide range of factors. IAG also announced a pick-up in investment income. The ongoing hard rate cycle will also benefit the insurance brokers, providing strong organic growth which is likely to be supplemented by acquisitions.

That said, no FY22 guidance was offered, but FY23 targets were reiterated. As in prior years, the general insurers did not provide EPS/DPS guidance, but previously announced FY23 margin targets were reiterated. For Suncorp, in particular, consensus remains sceptical whether its margin target and/or its cost to income target will be achieved, implying consensus upgrades will continue and a multiple re-rating remains possible on achieving its FY23 goals.

BNPL is scaling to take some market share from banks as their dominance increases

In fin-tech, the 'land grab' is accelerating, with commensurate rising bad debts as customer acquisition costs increase, and new-economy firms seek to sustain accelerated customer number growth. Consolidation and land grab accelerated with a focus on scaling merchant numbers. The Square / Afterpay transaction points to the accelerated need for scale in the payments space and accelerating consolidation. The payments landscape is becoming more integrated (merchants and customers) and integration with physical retail and ecommerce is the next stage of growth. In this market, scale matters most. The market is heavily fragmented with the potential for widespread consolidation. Subsequently, we have seen Affirm announce an agreement with Amazon. Though details remain limited at this point, it does point to BNPL (buy-now-pay-later) becoming mainstream, and the focus on growing merchants is increasing. In terms of reporting, 2H21 net loss rates increased as late fees fell and the funnel opened up. All major BNPL's saw 2H21 increases in loss rates as they increased conviction in unit economics and ability to invest. FY22 is expected to see revenue upside, but margin downside as investment increases. Greater customer acquisition costs are expected to see EBITDA decline, but lead to stronger top-line growth.

The health care sector remains strong, embraces digitisation

While the pandemic was difficult for elective surgery, face-to-face services, and pathology, it has been beneficial for other aspects of the health industry, producing a number of beneficiaries. Overall, health care sector reports show focused cost management and strong balance sheets. COVID has helped precipitate accelerated capex spending supporting digitisation programs and new and creative ways to deliver health care that can benefit the profitability of the industry. As such, the pandemic has helped in a way to strengthen competitive positioning across operators, with the pandemic shining a spotlight on the importance of healthcare services and pharmaceuticals, and consumers adjusting their behaviours out of necessity, helping bridge health care firms to a new, more efficient and potentially more profitable means of doing business.

Buybacks and special dividends underscored some excess cash in thriving companies

Table 2: Buybacks and Special Dividends

Buybacks	Sector	Mcap $m	A$m	% of Market Cap	Comment
AMC	Packaging	27,044	548	2.0%	US$400m on market
ANZ	Banks	81,267	1,500	1.8%	On-market buyback announced July
BSL	Steel	12,409	500	4.0%	On market buyback over next 12 months
CBA	Banks	179,166	6,000	3.3%	Off-market share buyback of $6b
IRE	Software	2,874	100	3.5%	On-market, up to $100m. In response to M&A offer
JHG	Asset Mgt	10,288	274	2.7%	Buyback boosted by US$200m (A$263)
LNK	Support Serv	2,413	150	6.2%	CEO committed to completing this one
NAB	Banks	90,694	2,500	2.8%	On-market share buyback of $2.5b
SUN	Insurance	15,639	250	1.6%	On-market share buyback of $250m in addition to the special dividend
TLS	Telecoms	45,908	1,350	2.9%	On-market, to commence in mid-September.
VEA	Fuel Stations	3,296	140	4.2%	$100m of capital return and $40m of on market buyback
WPR	Retail REITs	2,120	75	3.5%	Announced following asset sales, potentially more to come
WOW	Food Retail	51,961	2,000	3.8%	Off-market buyback
		525,079	15,387	2.9%	

Special Dividends	Sector	Mcap $m	A$m	% of Market Cap	Comment
APE	Auto Retail	4,211	22	0.5%	8.4cps special dividend following completion of Daimler trucks sale
BSL	Steel	12,409	96	0.8%	19cps special dividend
ILF	Asset Mgt	2,954	13	0.4%	2cps special from sale of non-core assets
OZL	Copper	7,409	27	0.4%	19cps special dividend
RIO	Mining	40,600	923	2.3%	Special dividend of US$1.85 or A$2.5 per share.
SUN	Insurance	15,639	101	0.6%	8cps special dividend fully franked
TLS	Telecoms	45,908	357	0.8%	3cps special dividend
WES	Retail	72,520	2,323	3.2%	$2 capital return in addition to normal dividend
		201,650	3,862	1.9%	

Source: Ausbil, MST Marquee

A range of buybacks and special dividends were announced to return capital, the highlight of which was the start of expected buybacks from banks, as illustrated in Table 2. While capital management was not at the same levels we have seen in recent reporting seasons, the buybacks announced by banks were a highlight, representing the strength of the economic rebound experienced in 2020/2021. These buybacks herald more of the same when the remaining three majors report their results after their 30 September year end.

Inflation is not yet a material threat to company earnings

Inflation in the form of major input increases was flagged by some specific sectors as a major concern this reporting season. The paper and packaging sector reported very strong inflationary pressures around freight and resin, however this was all passed through to customers with no margin impact. Inflation was also identified with respect to potential wage pressures by some diversified financials, with Computershare noting some wage inflation pressure in geographically cheaper operational centres given the ability to work from home. For Computershare, this additional expense was offset by a cost reduction program. Fund managers (Janus Henderson, Magellan and Perpetual) also noted elevated cost growth with higher staff costs associated with their attempts to capitalise on growth opportunities. By contrast, across the real estate sector, inflation was not called out as being material enough to negatively or positively impact the earnings outlook for companies. That said, lumber costs were mentioned in the context of adding some cost pressure to builders (Stockland made a passing comment on this). Lumber and freight costs were also called out by companies in commercial services as very high going into the results, however these costs were passed through to customers with little impact to companies. While insurers noted nothing out of the ordinary with respect to inflationary pressures, they are watching for building cost inflation in particular as a potential risk.

Pandemic-impacted supply chains are producing some challenges

There are well-known global supply chain challenges that are impacting many listed companies across a variety of sectors, and their ability to respond to increasing demand. This is manifesting itself in headwinds of higher freight costs and competition for components. Companies that have noted global supply chain challenges in recent results and trading updates include Wesfarmers (diversified retailing), Woolworths (consumer staples), JB Hi-Fi (retailing), Eagers Automotive (motor vehicle retailing) and ResMed (medical devices). Sectors where we are seeing some labour supply issues include: Agriculture that relies on a mobile workforce of itinerant workers; the Diversified Metals & Mining and Other Metals & Mining sectors, which are seeing supply issues impact some projects and test wages costs; in Information Technology with global semi-conductor chip shortages impacting manufacturing; and the Capital Goods & Chemicals and Commercial Services & Packaging sectors, largely on the back of surging demand for resources and construction services.

Real estate risk to consensus remains to the downside

Earnings revisions were mixed in real estate. REITs leveraged to rising asset values and development (Goodman Group and Charter Hall) continued to show strong underlying trends resulting in consensus upgrades across the forecast period. However, lockdowns and structural headwinds continued to result in material earnings downgrades for mall landlords (Scentre Group and Vicinity Centres).

Guidance was a feature. Contributing to the strong sector performance in August was that a number of REITs provided either FY22 EPS or DPS guidance, including Charter Hall, Centuria, Charter Hall Long WALE REIT and Dexus (DPS guidance only), Goodman Group, Growthpoint, Mirvac, National Storage REIT, Stockland and Scentre Group (DPS guidance only). On balance, guidance was framed as ‘at least’, suggesting some conservatism has been baked into initial guidance and an opening of the economy by October/November could see some upward revisions at 1H22 results in February (with Charter Hall, Goodman and Mirvac most likely).

The reopening trades appear fully priced. The ‘reopening theme’ resurfaced again in late August with Vicinity Centres and Scentre Group outperforming REITs and the market, despite the weak results and downgrades to consensus estimates. With a pick-up in vaccination rates, a strengthening in the narrative from NSW and now VIC premiers on reopening in October/November, this is now well understood and reflected in current share prices, whilst risk to consensus remains skewed to the downside.

Travel: The market remains committed to the reopening trade

In travel, the re-openers (Qantas, Corporate Travel, Flight Centre and Webjet) were re-rated by the market during reporting season despite all of them seeing very large EPS downgrades. These downgrades came from a combination of the continued delay in re-opening, and their currently diminished earnings base. The reopening trade in these names has been given a second chance by investors on the back of rapid vaccination increases across Australia, as noted earlier, and a growing confidence that the country will shortly be able to move beyond lockdowns.

Consumer staples face some challenges adjusting to their success

Trading updates for consumer staples were soft, broadly highlighting that comparable sales growth was below FY22 consensus sales growth, implying downside risk to FY22 consensus if sales trends are confirmed. The success of some consumer staples firms during the pandemic and in lockdowns has a flipside when lockdowns disappear and traditional custom is shared with a more broadly accessible range of staples options. Despite record earnings and strong balance sheets, capital management initiatives did not materialise in consumer staples. This is likely a reflection of the uncertainty retailers are faced with, including supply chain disruption creating inventory uncertainty, and lockdowns impacting sales and profitability. Another risk to the earnings outlook is the return of discounting, with almost all retailers confirming that promotional activities have returned as the industry attempts to stimulate sales (following a period of extraordinary sales growth). Discounting for custom will place downward pressure on gross margins and negatively impact operating leverage.

Industrials and automotives a mixed bag of pandemic and cyclical beneficiaries

In industrials, capital goods reported very strong activity levels in the resources space and infrastructure work, though with project timeframes expanding due to COVID/lockdown delays. However, success in capital goods names has seen some labour issues, particularly in WA, with fixed price contracts and schedules of rates more impacted due to loss in productivity and margin decline. The expected reopening of borders should significantly ease any labour shortage issues over the next 12 months.

Inflation in lumber and freight costs impacted the commercial services and supplies sector, however higher costs are being passed onto customers without negatively impacting margins, for now. Strong inventory build-ups by customers saw strong revenue growth, however this could make it more difficult cycling stronger comparable numbers. Waste management was impacted short term by pandemic restrictions due to volume declines in some areas, however this was relatively short lived. At this stage, there are no real inflation problems to call-out in the waste management industry.

Parts of the transport sector have seen very strong domestic volumes, benefitting from less competitive pricing in the space. Effectively, the industry (Aurizon and Qube) are fully-engaged with freight services in the pandemic world such that typically tight margins are strengthening significantly. At this stage in this extraordinary cycle, freight companies are price setters rather than price takers. While there are some wage-related pressures within the space, this is more than offset by strong revenue growth.

In the consumer discretionary sector, the auto industry is benefitting from better margins even with less cars to sell. In automotives and components (ARB, Bapcor, Eagers Automotive and GUD Holdings), auto dealers (Eagers Automotive) are continuing to benefit from the ongoing tailwinds of original equipment manufacturer supply shortages which is driving stronger gross margins (which is the biggest driver to profitability). This is due to chip shortages, with no signs of improving anytime soon. On the demand side, new vehicle sales continue to rebound from the lows in 2020 and, as they are closely correlated with the housing market, are still moving higher.

Construction materials continue cyclical growth, driving M&A

In building, pricing power is evident in the record levels of housing demand and disruptions in supply chains. Strong price growth is expected to continue into FY22, evidenced by expanding margins, even though raw material and freight inflation was an issue throughout 2H21 and led to a the tempering of consensus forecasts. M&A featured across the board during reporting season, and is expected to continue into the foreseeable future. Most companies are well-capitalised after raising capital throughout the depths of the pandemic, and a strict focus on cash preservation that has become fundamental to surviving these uncertain times. As economies begin to normalise, a number of companies are now looking for growth optionality which includes M&A. Recent examples include Boral (acquired by Seven Group through a majority, controlling holding), Reliance Worldwide (making a small bolt-on acquisition), Adbri (small acquisition), and Brickworks (also with a small addition to their business).

Telco competition is rational, for once, with asset realisations underway

Telcos, renowned for pricing away their margins, are in a surprisingly rational pricing market. Mobile competition has bottomed at the lower end of the market. Telstra is leading the pricing higher and Optus and Vodafone are following. Notwithstanding some noise about the $85 Vodafone unlimited plans (vs current average revenue per unit of $38.90), we are still seeing prices move higher and industry competition remaining rational. Asset realisation is expected to continue. Post-Telstra's successful towers transaction, there is increased management discussion on further asset realisations whether it is Telstra's InfraCo demerger or TPG potentially doing a tower sale. Looking out over FY22, mobile prices have bottomed and this is the most important driver of earnings, with FY22 risk to the upside.

Classifieds, cost inflation on staff but more than offset by monetisation and price initiatives

Leading indicators and current listings in classified markets (Seek, Domain Group and REA) are very supportive of underlying demand. Listings across all verticals remain positive, even with the current lockdown. The underlying trends remain very supportive. Cost growth is accelerating, with a rising tech spend on labour shortage but mostly in product investment. All companies exposed to the closed Australian borders flagged higher employee costs but, importantly, they all talked to being able to monetise the increased spend through higher pricing. A common metric across all providers was increasing prices in blunt terms, and also increased monetisation from penetration of higher revenue depth products. The platforms are all realising the value of their platforms and driving prices higher. In FY22, we expect more staff and R&D investment, more than offset by strong volumes and higher realised prices.

Media – stronger revenue but matching with content investment

Content investment is increasing but matching revenues. The ad market remains strong and so while the listed companies are talking to increasing content investment (TV and sports), this is a function of the revenue environment. The ad market is strong even with the lockdowns. Notwithstanding this, the advertising market remains very strong and points to a strong 4Q as lockdown ends. In FY22, we see more content investment, but we are not expecting margin compression given a strong advertising market. We are also into an election year, and this is typically a net-positive for advertising spend.

Equity Market Outlook

Ausbil had projected FY21 to be one of the best earnings years on record following the rebound from COVID lows in 2020. FY21 reporting season delivered circa +27% in EPS growth (S&P/ASX 200), rebounding from a -17% EPS decline in the FY20 pandemic year. With stimulus in place, low interest rates, and inflation that is not threatening to monetary policy in the near term, we see stronger company balance sheets ready to deliver another strong year of earnings growth in FY22, with consensus EPS growth at +16.7% (S&P/ASX 200) and +16.1% (S&P/ASX 300). While FY22 lacked guidance from companies, during reporting management teams have flagged significant investment plans for when economies normalise beyond lockdowns. We see this as a lead indicator for earnings growth surprises in FY22, and moving into FY23. In our view, FY21 is the first of a trilogy of strong positive earnings years that we expect to see play out across FY22 and FY23 (though consensus estimates are currently for a slight negative EPS growth in FY23), with a backdrop of Australia achieving vaccination targets in the near term, and releasing pent-up spending and demand.

Ausbil remains positioned for the continued economic expansion, albeit somewhat impacted by lockdowns, with the added boost of a rebound once vaccination targets are achieved and the economy can recommence its path towards normalcy. As always, we expect some volatility and uncertainty along the way. While we are not worried about inflation at this stage, we maintain a diligent watch on the global inflation numbers. We remain invested in what we believe are some of the best quality companies, which exhibit superior underlying earnings growth and strength, with the aim to achieve longer-term outperformance.

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