February 2021 — Over the Horizon Market Commentary by David Offer

While the month of February started strongly and by mid-month was up over 4%, over the latter half of the month the share market subsequently weakened. Consequently, the All Ordinaries index finished up a more modest 1% to close the month at 6,940 points.

February is interim reporting month for most Australian companies. Overall, company results were much better than anticipated. When listening in on a number of company interim profit conference calls, it was evident that there is a high degree of business confidence for the year ahead. Broadly speaking the interim reporting season saw 56% of companies report a rise in profits, up from just 36% six months ago. 51% of companies exceeded share market expectations compared to just 32% six months ago and 47% of companies have increased dividends compared to 55% cutting dividends six months ago. Off a low base, thanks to last year's COVID induced lockdowns, the outlook for corporate Australia is continuing to improve at a faster rate than previously expected. As a result of the strong rebound in profits, more beats than misses and positive guidance, consensus expectations for earnings growth in 2020-21 have now been revised up to 34%, up from +21% a month ago and just 8% six months ago.

This improvement in profits can be largely attributed to the iron ore sector (BHP, RIO Tinto, Fortescue and Mineral Resources) as well as a rapid rebound in the banking sector thanks to buoyant property markets across the nation stimulating lending and allowing banks to unwind bad debt provisions that had increased dramatically last year when the future impact of COVID was unknown.

Due to the conservatism of corporate Australia last year, the balance sheet for corporate Australia is in excellent shape. This should lead to a significant rebound in dividends paid over the next few years. In the absence of any return from cash in the bank, a recovery in dividends will be welcomed by investors.

While we repeatedly stated that we view the share market as having pockets of extreme overvaluation, it is both pleasing and a relief that we also view a large number of listed Australian businesses as offering reasonable value at the current time. Following my letter is a list of some of our current preferred buys, along with a link to research and analyst comments on how they have viewed respective results.

In terms of areas of overvaluation within portfolios, following on from recent share price rallies, one area of caution is our largest Four Banks. While earnings are set to recover strongly, this is now likely to be factored into current share prices. The Banks are not going to return to their glory days of year in year out profit growth of 7-10%. This was largely achieved through cross selling other financial products such as superannuation and insurance. Post Royal Commission, the big Four Banks have returned to focusing purely on banking, which is inherently more cyclical and lower margin. While Australia's current property lending binge will be helpful, profit growth through the cycle will primarily be from cost cutting as the banks 'shrink to greatness'. This will be evident by the continuing ongoing reduction in the size of respective bank networks around the country. Using ANZ as an example, Morningstar forecasts that by 2023, by which time our Banks should be operating in a more normalised environment, that ANZ will be trading on a Price Earnings ratio of 13.5 times and dividend yield of 4.8%. In a historical context, this is not cheap and as such we will progressively look to reduce client exposure to bank shares where overweight in portfolios.

Another area of overvaluation within portfolios is in retailers including Coles, Woolworths and Wesfarmers. In Coles interim profit announcement, the Company summed up the earnings challenge for the rest of the year, and into the 2022 financial year with the following statement. "Depending on COVID-19, vaccine roll out and efficacy, and other factors, sales in the supermarket sector may moderate significantly or even decline in the second half of FY21 and into FY22." Coles has already seen a slowing in sales early in 2021.

While ANZ, WBC, NAB, CBA, Coles, Woolworths and Wesfarmers are 'comfortable' shares to hold, particularly given they display large unrealised gains on portfolio reports, we need to be mindful of what constitutes a 'good share'. A 'good share' is defined not by the share price appreciation to date but rather, what the share price appreciation will be for investors into the future.

Finally, two top 20 shares that are starting to appear on our investment radar are CSL and RIO Tinto. At $250, CSL has retreated significantly from its highs of $330 achieved last year. COVID has impacted the Company's blood plasma business but this should rebound as the impact of COVID subsides and as CSL's investment in plasma collection centres comes to fruition. CSL is the second largest manufacturer of influenza vaccines globally and, thanks to COVID, annual vaccinations should continue to increase across the population going forward. Finally, the Company has an extensive R&D pipeline which should generate new revenue streams into the future. Offsetting this is CSLs current expensive valuation. Should CSL slide a little further to around $230 a share, we would be willing to start acquiring shares and would become a strong buyer in the Company sub $200 a share.

RIO Tinto (RIO) has recently slid from $130 a share to $115 a share. While we don't expect the Company to maintain current profits in the medium term, the sheer rate of profit being generated at the current time is hard to ignore. RIO is presently on a dividend yield of 10% and PE Ratio of just 8 times. On any further weakness, RIO becomes a strong buy. We don't agree with Morningstar's excessively bearish long term iron ore assumption of just $US42 a tonne and therefore Morningstar's valuation on RIO of just $79, which has barely moved despite the massive boom in iron ore sales in over the last year. While we strongly expect the iron ore price will weaken over the long term, there is no certainty as to when this will occur and to what extent. While we wait, shareholders can enjoy excessive dividend returns. While iron ore is RIO's key profit driver, the Company has some diversification with extensive aluminium and copper businesses. These sectors arguably have significant upside as we move towards a lower global carbon economy. RIO has significantly underperformed the other iron ore miners such as BHP, Fortescue over the last 12 months and this may be in part due to ESG issuers stemming from the blowing up of the Juukan caves. Hopefully RIO has learned from its mistakes and this issue will subside in time.

If you would like to discuss any of the companies discussed in this month's letter or your investment portfolio in general. Please do not hesitate to contact our office.

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Analyst Comments on Key Recommendations

Amcor - $15.03 (Fair Value $16.30)

Heightened at-home consumption of consumer staples categories--amid the ongoing coronavirus pandemic--drove strong demand for Amcor's flexible and rigid plastic packaging in the first-half fiscal 2021. While flexible packaging volume growth of 2% tracked modestly ahead of our full-year expectations, first-half rigid packaging volume growth was incredibly strong at 6%. Having upgraded our full-year volume expectations--which had previously factored a modest coronavirus-related headwind to household consumption and related consumer packaging demand--we increase our full-year fiscal 2021 EBIT estimate by 5% to USD 1,638 million. As a result, our 6% upwardly revised fiscal 2021 EPS forecast of USD 72.8 cents sits toward the upper-end of Amcor's upgraded full-year EPS guidance range of USD 70.6 cents-USD 73.2 cents. While fiscal 2021 is shaping up better for Amcor than we'd previously anticipated, our long-term expectations remain unchanged. Therefore, we make no change to our AUD 16.30 per share value estimate. Amcor shares screen as undervalued, last trading at an 8% discount to our valuation. First-half volumes benefited from strong demand in consumer staple categories--including flexible packaging categories of meat, frozen food, pet food, home and personal care, as well as North American rigid beverages. Elevated end-user demand for household staples reflected heightened at home consumption, as social distancing protocols remained in place across Amcor's key geographies of the Americas, Europe, and Asia Pacific during the first-half. The strength in consumer categories offset weakness in Amcor's healthcare franchise which has suffered fiscal 2021 year-to-date from dramatically reduced elective surgeries and pharmacy visits amid the pandemic. (Morningstar)

Brambles - $10.07 (Fair Value $12.90)

Strong volume momentum persisted into Brambles' first half of fiscal 2021, reflecting the ongoing increase in at-home consumption of fast-moving consumer goods and consumer staple categories amid the coronavirus pandemic and market share gains in central Europe for the Europe, Middle East, and Africa segment. With pallet demand in early fiscal 2021 tracking ahead of our full-year expectations for Brambles' global franchise, we increase our full-year 2021 EBIT estimate by 3% to USD 851 million. The upgrade to our fiscal 2021 EBIT estimate implies 7% year-on-year growth and sits at the top end of Brambles' upwardly revised fiscal 2021 EBIT guidance of 5% to 7% growth. Despite the strong start to fiscal 2021, our long-term expectations for the wide-moat stock are unchanged, as is our AUD 12.90 per share fair value estimate. With Brambles' shares trading at a significant discount to our unchanged valuation, investors continue to underappreciate the substantial medium and long-term secular growth opportunities available to the global leader in supply chain pallet-pooling solutions. Specifically, we expect the continued secular growth of Brambles' North American and European pallet pools to underpin a 10-year group EBIT CAGR of about 9.5%. Longer-term expansion opportunities in emerging markets add an estimated AUD 1.40 to our per share fair value estimate. For greater detail regarding Brambles' secular growth opportunities, please see our Nov. 26, 2020, special report "Brambles Has Truck Loads of Emerging Market Growth Potential." Government-imposed lockdowns--aimed at containing the spread of the coronavirus--ravaged economies globally in the first half of calendar 2020, including Brambles' key markets of North America and Europe, which contribute a cumulative 94% of group operating income. Subsequent relaxation of restrictions on movement and on economic activity saw the U.S. economy bounce back in the latter half of calendar 2020. (Morningstar)

Perpetual - $32.02 (Fair Value $39.50)

Headline numbers in narrow-moat Perpetual's first-half fiscal 2021 results were unspectacular, but they aren't indicative of its future earnings capacity. Underlying net profit after tax was down 11% from the prior corresponding period to AUD 52.6 million, largely due to lower average funds under management and lower fee revenue in its Australian investments division. This was partly offset by earnings contribution from its international investments business and resilient earnings from Perpetual Corporate Trust. We lower our fair value estimate to AUD 39.50 per share from AUD 41, mainly after revising our assumptions on expenses and working capital. The uplift in cost guidance largely reflects greater-than-expected operating costs in the international investments business and corporate trust, as well as higher distribution expenses for both investment businesses. We view the increased spending in distribution as necessary to steady Perpetual's competitive position and revive fund inflows after two consecutive years of declining group earnings. The international investments business is Perpetual's core growth driver, and we expect this segment to help the firm increase underlying EPS at 7.5% per year through to fiscal 2025, off a low base in fiscal 2020. Progress on expanding the international investments business, which comprises Barrow Hanley and Trillium, remains the central theme. We anticipate net inflows starting fiscal 2022, averaging 2.3% per year and helping to increase FUM at a CAGR of 9% through to fiscal 2025. With more distribution staff, a diversified clientele, and established relationships with asset consultants and research firms, Perpetual is at core a better distributor than Brightsphere (the previous owner of Barrow Hanley), which we understand was more focused on investment management. Perpetual commenced promoting in the U.K., EMEA, and Asian markets and will also work on selling to retail and intermediary clients. (Morningstar)

Cimic - $18.75 (Fair Value $33.00)

We make no change to our AUD 33.00 fair value estimate for no-moat Cimic. The company reported a 25% decline in underlying 2020 NPAT to AUD 597 million, close to our AUD 592 million forecast. Statutory NPAT increased to positive AUD 617 million from negative AUD 1.04 billion, including on a post-tax basis positive AUD 1.4 billion on the divestment of 50% of Thiess, substantially offset by AUD 805 million non-cash Gorgon Jetty resolution and AUD 613 million in other impairments, provisions, and costs. The prior year included large Middle East exit costs. With a seemingly confusing picture of material gains and losses, it pays to head to the cash flow statement. Net operating cash flow fell to negative AUD 265 million, including negative AUD 1.5 billion lagged cash impact from the prior year's Middle East exit, considerably better than we were expecting. And free cash flow increased to positive AUD 1.3 billion from negative AUD 262 million, including Thiess sell-down proceeds, again much better than we'd expected. This enabled the group to retain a modest net cash position of AUD 186 million despite AUD 281 million in buybacks which reduced shares on issue by 4% to 311 million. The average buy-back price of AUD 22.60 wasn't looking too bad until apparent market disappointment with the earnings result led to the shares plummeting 17% to AUD 21.56. Still, purchases at considerable discount to our fair value are to be commended. Market disappointment seems to centre around 2021 earnings guidance. One year's earnings does not a company make. Cimic reinstated dividends in the second half declaring a final of AUD 0.60 per share, a 67% payout of underlying second-half earnings. This was ahead of our AUD 52 cent forecast on a higher payout and equates to an annualised 5.6% yield at the current share price, though franked to just 20%, and projected to fall. Our 2021 DPS forecast declines to AUD 0.80 on a 60% payout. (Morningstar)

Lendlease - $13.36 (Fair Value $14.45)
No-moat Lendlease reported first-half operating earnings per security of AUD 0.298 and a distribution of AUD 0.15. We expected a second-half skew to earnings, so we think Lendlease is tracking towards our full-year estimates of AUD 0.65 and a distribution of AUD 0.33. We expect a better second half mainly because several development projects could hit milestones that prompt capital partners to buy in, which would allow Lendlease to realise development profits. We make no change to our earnings estimates, and our fair value estimate remains AUD 14.45. As expected, there wasn't much news of sales for finished or partially completed product at the first-half result. While we expect a better second half, the group telegraphed that development is constrained in the short term, meaning Lendlease may disappoint market expectations in fiscal 2021, and potentially fiscal 2022 as well. About half of the company's massive AUD 110 billion development pipeline was secured within the last three years, and the time from origination to planning approval is typically two to three years. Construction can take two years, and Lendlease typically starts each building once it reaches a threshold of tenant pre-commitments (for rental developments such as offices or build-to-rent residential), or pre-sales for build-to-sell residential. Current share price weakness is likely a result of frustration in waiting for earnings, but therein lies the opportunity for the patient investor. Lendlease has substantial earnings power in the medium to long term, thanks to its project pipeline. Despite the first half's minimal development completions, value is being created behind the scenes via planning progress, and pre-sales of incomplete projects. Given the low interest rate environment, Lendlease has good odds of selling partial stakes in projects to capital partners at full prices, especially given negotiating power tilts further in its favour the more the global economy recovers. (Morningstar)

Worley - $10.33 (Fair Value $12.00)
Following a post first half fiscal 2021 result review, we reduce our fair value estimate for no-moat Worley Limited by 4% to AUD 12.00 per share. First half fiscal 2021 underlying NPAT fell 55% to AUD 79 million, considerably below our forecast. We've consequently tempered the rate of margin recovery. Our five-year revenue CAGR forecast of 3.4% to AUD 13.3 billion by fiscal 2025 is little changed. But we have reduced our midcycle EBITDA margin assumption to 8.8% from 9.5% prior. Mix shift plays a part with Chemicals margins lower than for Energy. Time-value-of-money limits the impact on fair value. Underlying first half fiscal 2021 EBITDA margin fell to a lower than expected 5.7% versus 7.2% in the pcp. The COVID-19 pandemic impacted Worley's customers in their end markets, and project deferrals and site access restrictions reduced volumes. Negative operating leverage was a significant damper as revenues declined faster than costs. We expect this to provide an upside benefit for the latter part of fiscal year 2021 as deferred projects from the first half complete. We still anticipate material margin benefit through cost savings, with Worley delivering a total AUD 125 million in annualised savings during first half fiscal 2021. Much in the recent past has come from Jacobs ECR acquisition cost synergies which so far amount to AUD 181 million on an annualised basis. But further gains from this source are largely tapped, with Worley's ultimate target of AUD 190 million already exceeding its original of AUD 130 million. Most of first half fiscal 2021 and future gains have and will now come from operational savings. Worley shares have drifted around 20% from circa AUD 14.00 November 2020 highs, but at AUD 10.95 screen as only somewhat undervalued. Our fair value estimate equates to a fiscal 2025 EV/EBITDA of 7.2, a PE of 15.8 and dividend yield of 4.7% (Morningstar)

United Malt - $4.00 (Fair Value $4.50)

No-moat United Malt Group reported at its annual general meeting continued end-market demand pressure, related to ongoing pub and restaurant closures which have negatively impacted brewing and distilling customers. We're not surprised by this commentary. We had expected any rebound in fiscal 2021 (September year-end) to be weighted toward the back half of the year as benefits from vaccines in the U.S. and Australia lead to venues reopening, and United enjoys additional capacity in Scotland from a new facility opened in January 2021. We've pulled back our revenue growth forecast to 1.4% from 5.6% previously due to foreign currency headwinds, but continue to expect a top line rebound as the year progresses. However, management's outlook for first-half EBITDA of AUD 47 million to AUD 50 million puts it behind the run rate to meet our prior full-year AUD 156 million forecast. We had already expected EBITDA margins to retreat slightly, to 11.5% this year from 11.8% in fiscal 2020, owing to rising corporate expenses and last year's one-time benefits such as temporary staff cuts. But we've reduced our forecast to account for the lower first-half outlook. We now expect margins to slide to about 11%, leading to EBITDA of AUD 146 million. Nonetheless, we remain optimistic about United's future profitability expansion, and maintain our AUD 4.50 per share fair value estimate. Some of the first-half challenges stem from one-off costs such as redundancy associated with a closed facility in England and business efficiency investments, both of which should lead to future bottom line benefits. And we anticipate the company will reduce its corporate expense line over time, which is set to cost United Malt about AUD 12 million in fiscal 2021. We expect the firm to enjoy high-single-digit average annual revenue growth starting in fiscal 2022 as end markets normalise and the company adds additional capacity in Scotland, while EBITDA margins climb to 14% over the long run. (Morningstar)

Woodside - $25.22 (Fair Value $40.00)

We reduce our fair value for no-moat Woodside by 10% to AUD 40 per share. The company reported a 58% decline in underlying 2020 NPAT to USD 447 million, or AUD 0.69 per share, not far from our USD 457 million expectations. But in an unrelated move, we temper the value ascribed to cash flows accruing beyond 2030. This somewhat more cautious approach is more academic than actionable, with the shares remaining well below fair value, deep in 4-star territory. We still forecast group production increasing by 25% to 125 million barrels of oil equivalent, or mmboe, by 2026 on construction of a second Pluto LNG train. Underlying 2020 earnings exclude a USD 3.9 billion non-cash post-tax impairment for lower hydrocarbon prices and USD 447 million onerous contract provision at Corpus Christi. A final fully franked USD 0.12 dividend is as expected, in accord with the 80% payout policy, bringing the full year to USD 0.38 and a modest 2.2% yield at the current AUD 25.20 share price. The dividend is reflective of a COVID-19-impacted crude price and not indicative of future payouts. We forecast an improved AUD 1.24 dividend for 2021 and an effective 4.9% yield. Woodside shares have increased 60% from virus-dampened crude price lows in March last year. But we still think the market unwisely underprices for growth potential. The chief underpinner remains construction of a second Pluto LNG train. Our reduced fair value equates to a 2030 EV/EBITDA of 8.4, excluding the USD 5.5 billion lump sum we credit for contingent resources in Kitimat Canada, Senegal, and so on. Our midcycle Brent price is unchanged at USD 60 per barrel in 2022 dollars. We credit a 10-year EBITDA CAGR of 7.8% to USD 6.2 billion. This presumes a 25% increase in group production to 125mmboe, by 2026. Equally importantly, global LNG demand is forecast to continue to grow strongly. Market expectations are for strong 10-year global LNG demand growth. We expect Woodside will find a home for its expanded gas output. (Morningstar)

Tassel - $3.49 (Fair Value $3.90)
We continue to focus on likely earnings in more normal conditions. We saw little surprise in the 1H result, which while modestly ahead of our estimates, confirmed the expected impact from weak global salmon prices more than offsetting increased production volumes. Our outlook is also substantially unchanged: inherent short-term forecast risk and earnings drag persists while COVID-19 continue to impact prices across export channels (with some domestic flow-on). Our recent downgrades largely took this into account, hence EPS changes are modest. We continue to focus on what TGR could look like in FY22 and beyond, where (at least by the 2H), the beginnings of a price recovery that should flow from post-COVID conditions, together with ongoing cost efficiencies, should drive a strong earnings growth story in FY22-23. No change to Outperform rating or TP of A$3.90. (Credit Suisse)

Suncorp - $10.50 (Fair Value $12.50)
Suncorp's first-half fiscal 2021 cash profit increased 40% on first-half fiscal 2020 to AUD 509 million, putting the insurer on track for a strong rebound in full-year earnings. Recall earnings in first-half 2020 bore the brunt of the Australian bushfires. Profit is also up 33% on second-half fiscal 2020 earnings, which were impacted by COVID-19-related provisions in insurance and banking. This half isn't without large notable costs though, with AUD 114 million in business interruption insurance provisions, slightly higher than the estimate announced in November 2020. Underlying trends were overall positive, with growth in policies and pricing for insurance, net interest margins for the bank up 8 basis points from six months ago, and loan losses representing just 0.03% of loans. The result also got a boost from investment income on Australian insurance and shareholder funds, which bounced to AUD 305 million from AUD 136 million last year. With the majority attributable to mark-to-market gains due to favourable moves in equity and bond markets, we expect second-half investment income to be much weaker given the low-rate environment. We increase our fiscal 2021 earnings forecasts 6% to AUD 911 million, adjusting for stronger bank profits and higher interest income on shareholder and insurance funds, partially offset by modestly higher insurance claims. Suncorp remains modestly undervalued with our long-term earnings forecasts and AUD 12.50 fair value estimate unchanged. On better than expected earnings and a 65% payout ratio (compared with our 50% forecast), the interim dividend of AUD 26 cents per share was higher than we forecast. The dividend matched first-half fiscal 2020 levels and was meaningfully higher than the AUD 10-cent dividend paid in second-half fiscal 2020. We expect a 90% payout on second-half earnings, lifting full-year dividends to AUD 52 cents per share. This would take the full-year payout to 76%, within the board's 60%-80% dividend target range. (Morningstar)

Origin - $4.50 (Fair Value $7.00)
No-moat rated Origin Energy reported a weak first half fiscal 2021 result, as expected. Underlying EBITDA fell 27% from the prior corresponding period to AUD 1.15 billion mainly on lower LNG and electricity prices, while underlying profit slumped 58% to AUD 224 million on the above factors and faster depreciation of soon-to-be-replaced retail IT systems. Although the interim result was close to expectations, we upgrade our full year NPAT forecast by 3% to AUD 390 million because of recent strength in oil prices, which flow through to contract LNG prices with a roughly three-month lag. Oil prices have increased sharply since November last year and are now sitting above our long term USD 60 per barrel forecast, suggesting the APLNG joint venture will have a solid second half. We maintain our AUD 7.00 fair value estimate and consider the stock attractive. It trades at a 36% discount to fair value and offers a forecast unfranked dividend yield of 5.5%, with material upside as earnings recover and on a higher payout ratio as financial health improves. We forecast dividends almost doubling over the next five years. Energy markets--the utility business--reported EBITDA down 12% to AUD 635 million as lower wholesale electricity prices progressively flow through to customers. Lower gas prices and roll off of favourable gas pipeline contracts also detracted from earnings. Volumes for gas and electricity were solid. The energy markets business is expected to remain under pressure in coming years, similar to peer AGL Energy, as customer tariffs reset lower to align with wholesale prices; retail prices reset each year while business customers are typically on two- or three-year contracts. We forecast full year EBITDA falls 28% to AUD 1.06 billion, with another 12% downside in fiscal 2022. (Morningstar)

Link - $4.84 (Fair Value $6.90)

Narrow-moat-rated Link's interim result wasn't a huge surprise as key elements were announced last month, and management provided a business update in December. But more information on the performance of individual divisions and the outlook statement were revealing. Although we've largely maintained our short-term earnings forecasts, we've cut our long-term group profit margin assumptions slightly. And the changes to our earnings forecast have caused a 5% cut in our fair value estimate, to AUD 6.90 per share. However, at the current market price of AUD 4.84, Link shares still screen as undervalued. Management confirmed that the Pacific Equity Partners, or PEP, and Carlyle Group consortium are continuing to explore an acquisition of Link, following their increased indicative nonbinding offer of AUD 5.40 last October. Link's board previously said that the consortium's original AUD 5.20 offer "materially undervalued" the company, and we also doubt they'll recommend the current offer. Link fared reasonably well during the pandemic and managed to avoid a dilutive equity capital raising when the market slumped last March. This is testament to the defensive attributes of the company, which has a high proportion of recurring revenue. However, Link's diverse portfolio of businesses has still been impacted by a range of factors over the past couple of years, which have crimped earnings and the dividend. A 30% fall in the interim dividend, to AUD 4.5 cents, 60% franked, reflects recent earnings weakness, but we expect the dividend to improve as earnings rebound. We also expect franking to remain around 60% due to the earnings contribution from overseas businesses. (Morningstar)