Contact Asset Management

INSIGHTS

MARCH 2021

February Reporting Season Review

The February 2021 Reporting Season was the best in many years. Many feared a lot worse as the reverberations of COVID-19 continue to impact most industries. Australian businesses have displayed a keen ability to innovate and adapt, which has put many in good stead. The earnings recovery continues to gather steam.

Welcome to the latest edition of *Contact Insights*. In this note, we reflect on the February earnings season – one of the best reporting periods in several years. Higher than expected profits and improved dividends were two of the key themes that emerged in February. However, a lot of the good news appears to have been anticipated as share price reactions were quite muted. Below, we consider some of the key themes that we deemed interesting in February including: the re-emergence of dividends, the status of the economic recovery, COVID "winners" and "losers" and supply chain pressures which are intensifying. We cover several stock specific highlights under each of these themes.

The re-emergence of dividends

Calendar 2020 was an awful period for yield hungry investors as company dividends were slashed. The following slide from the BKI Investment Company 1H21 presentation paints quite a powerful picture of the extent of the dividend cuts in the second half of calendar 2020.

The extent of Dividend Cuts in the second half of 2020 was unprecedented. This was hopefully the low point.

	Stock	*Change in Dividends Received*		*Stock*	*Change in Dividends Received*
1	Macquarie Group	-46%	14	Woodside Petroleum	-32%
2	Commonwealth Bank	-58%	15	Telstra Corporation	-38%
3	BHP Group	-30%	16	Harvey Norman Holdings	-14%
4	APA Group	4%	17	Magellan Financial Group	10%
5	Transurban Group	-52%	18	Coles Group	10%
6	Wesfarmers Limited	-4%	19	Invocare Limited	-69%
7	Woolworths Limited	-16%	20	Fortescue Metals Group	317%
8	National Australia Bank	-12%	21	Amcor	30%
9	TPG Telecom Limited	-100%	22	New Hope Corporation	-100%
10	Ramsay HealthCare	-100%	23	Goodman Group Limited	0%
11	Sonic Healthcare	0%	24	Rio Tinto Limited	-1%
12	ARB Corporation	88%	25	NAB Convertible Notes	100%
13	ASX Limited	7%			

Source: BKI Investment Company, 1H21 Results Presentation, January 2021

Fortunately, it appears that we are now past the worst of the dividend cuts as we emerge out the other side of COVID. As noted by Morgans Research, *"the number of dividend paying companies has increased to 57% from 53% in August. And as a sign of renewed corporate confidence, 43% are paying a higher dividend than the full year"*. We consider dividends to be an important indicator of business quality and confidence in the outlook. Companies who have the ability to pay a dividend proves to us that their business model works.

Several of our major holdings across Contact's managed products announced a pleasing dividend outcome during the latest reporting season. The Commonwealth Bank dividend of $1.50/share was very well received and reflected a payout ratio of 68% following

APRA's relaxed limitations on Bank dividends. With a remarkably strong capital position of Tier 1 Capital at 12.6%, we consider there to be a high probability of increased ordinary dividends and additional capital returns in the year ahead. The other major banks are likely to increase dividends markedly when their results are announced in May.

The biggest boon came from the iron ore miners, who have enjoyed prolonged periods of record prices. The cash generation is eye watering. This was reflected in significant dividend growth. BHP Group's dividend was up 31% on 1H20, Rio Tinto's dividends (including specials was up 47% and Fortescue Metals Group dividends were 93% higher!.

The major retailers have enjoyed buoyant trading conditions in the past twelve months and are among the very highest "COVID winners" (more on that below). The income from Coles, dividend up 10% on 1H20, Wesfarmers dividend up 17% and Woolworths dividend up 15% reflected the buoyant conditions.

Among the small and mid-cap names, there was also plenty of good news on the dividend front. In a similar vein to the Coles, Wesfarmers and Woolworths example above, many retailers enjoyed a prosperous six months. In particular, ARB Limited increased their interim dividend by 57% and Harvey Norman returned to paying an interim dividend having had to cancel their 1H20 dividend. Gerry Harvey summed it up well when he said, *"I've been doing retail since the late 1950s and I've never seen anything like this. We've seen ups and downs and recessions but retail in Australia has never seen this… That's happening right across the world, it hasn't stopped. In April, May and June, sales went through the roof and it hasn't stopped in January and February".*

The status of the economic recovery

A common theme through Reporting Season management briefings has been the significant improvement in operating conditions and confidence from six months ago. Australia's world leading ability to deal with COVID has been reflected in buoyant corporate earnings. As Rob Scott, CEO of Wesfarmers, said: *"Economic conditions in Australia have recovered strongly and the outlook is more positive"*.

Across the board, the economic conditions continue to improve. NAB Business confidence lifted to +10.0 (previous +4.7) and the Westpac Melbourne Institute consumer sentiment rebounded to 1.9% in February from negative4.5% in January.

Household balance sheets are strong, and unemployment has not hit the levels feared in mid-2020. Mirvac CEO, Susan Lloyd-Hurwitz noted at the February result that, *"Households have accrued a large stock of savings through 2020 due to periods of restrictions, and fiscal and monetary stimulus. Together with an improving employment market and evidence of growth in wages and salaries, prospects for continued recovery in retail consumption are expected".*

For now, the Reserve Bank seems determined to do whatever it takes to protect jobs and the economy. In a February speech, the RBA Governor noted that *"On the nominal side of the economy, there is also a fair way to go. In underlying terms, inflation is running at 1¼ per cent, well below the medium-term target of 2–3 per cent. And wage growth is the lowest in decades".* However, on a more positive tilt, he also noted that *"Our central scenario is for the upswing in the Australian economy to continue, with above-trend growth over the next couple of years. GDP is expected to increase by 3½ per cent over both this year and 2022. Given the recovery we have seen so far, we are expecting the level of GDP to return to its end-2019 level by the middle of this year, which is 6 to 12 months earlier than we previously expected."*

With interest rates at record lows, household finances and confidence in good shape and a business community that has shown the ability to innovate, we believe that the near-to-medium term prospects for the Australian economy and equities markets remain robust.

The COVID "winners" and "losers"

As positive news flow from the vaccine rollout continues, there has been increased buying of the COVID losers. February saw stronger share price performance from the COVID losers despite not delivering the same level of earnings growth as the Covid winners. In fact, many of the Covid winners had a de-rate of valuation metrics as the market started to assess the business performance as many companies cycle tough comparative periods. During the recent reporting season, the major retailers (some of the COVID winners) have already cautioned around tough comps in the fourth quarter of FY21. Coles also noted it is starting to see the impact of reduced immigration and softer sales as the economy normalises.

Some of the obvious COVID losers have been travel related stocks – many of which caught a bid in February as investors speculated on the reopening trade. The positive vaccine news boosted sentiment. Corporate Travel Group and Flight Centre, neither of which are owned by Contact-managed portfolios, increased by 20% and 17% respectively for the month.

The banks were certainly COVID losers early on but have led the market higher in recent months as investors assess that provisions for impairments are more than adequate. When Westpac wrote back over half a billion dollars in provisions with its third quarter

update, it was a powerful signal. Westpac CEO Peter King noted, *"The economy is recovering, consumer and business confidence is strong, and the labour market has been much more resilient than expected."*

Many healthcare stocks faced a similar experience to the Banks in that the lockdowns and restrictions hurt early but the recovery has been real. In our opinion, one of the best results was Sonic Healthcare, which is the world's third-largest medical laboratory company, with facilities in eight countries. SHL management reported a recovery in traditional pathology collection volumes in the six months to December 2020, however it is the growth from COVID testing globally which supercharged profits. Revenue increased by 33% and EBITDA was 89% higher reflecting the strong operating leverage in the business. The tailwinds are set to continue as COVID serology testing (immunity status) is likely to be the next growth driver for Sonic.

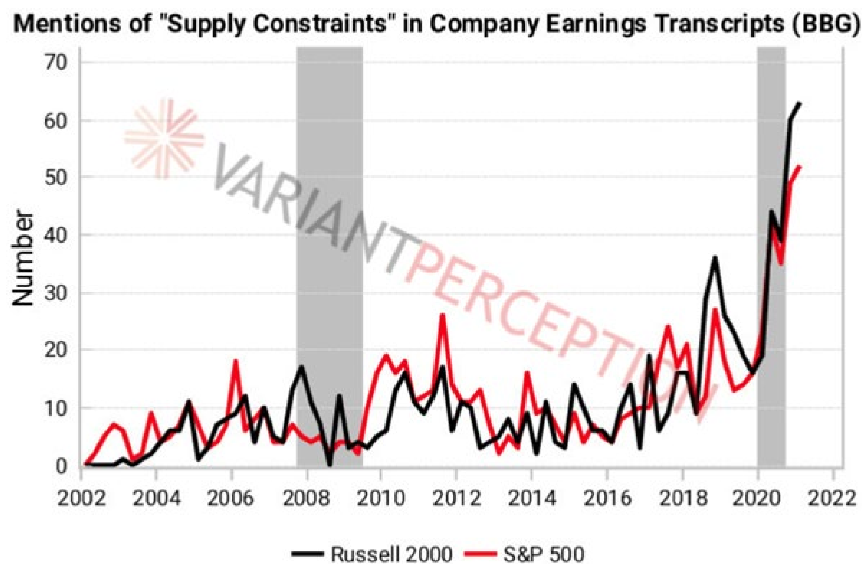
Looking forward, we anticipate that there will be less talk of the "COVID winners and losers" as the vaccines are rolled out more broadly. Sooner or later, companies will be assessed on the ability to deliver sustainable earnings and dividend growth. Quality will lead the way.

Supply chain pressures

One thing that we have been watching closely over the last year is the increasing pressure on supply chains. For example, freight costs have increased markedly which for those companies who have little to no pricing power will pressure operating margins. Many industrial companies and retailers that we met during February and early March discussed the strain in many parts of the supply chain including access to inventory and spare parts.

ARB Limited had one of the best results during reporting season as it has benefited from the regional tourism boom that is playing out in countries all over the world. The demand is unprecedented. In a post results discussion, CEO Roger Brown said that *"there is still strain everywhere and one of our biggest challenges is managing customer expectations."* When asked if he thought the backlog would be cleared by the middle of the year, he responded *"The backlog cannot get cleared in four months. We would have to have no new orders for four months to clear the current backlog"*.

We found the following chart interesting. While the data is based on the US earnings season, we believe that we can safely assume that the same trend was evident in the Australian corporate earnings calls. "Supply constraints" are becoming an increasing concern.



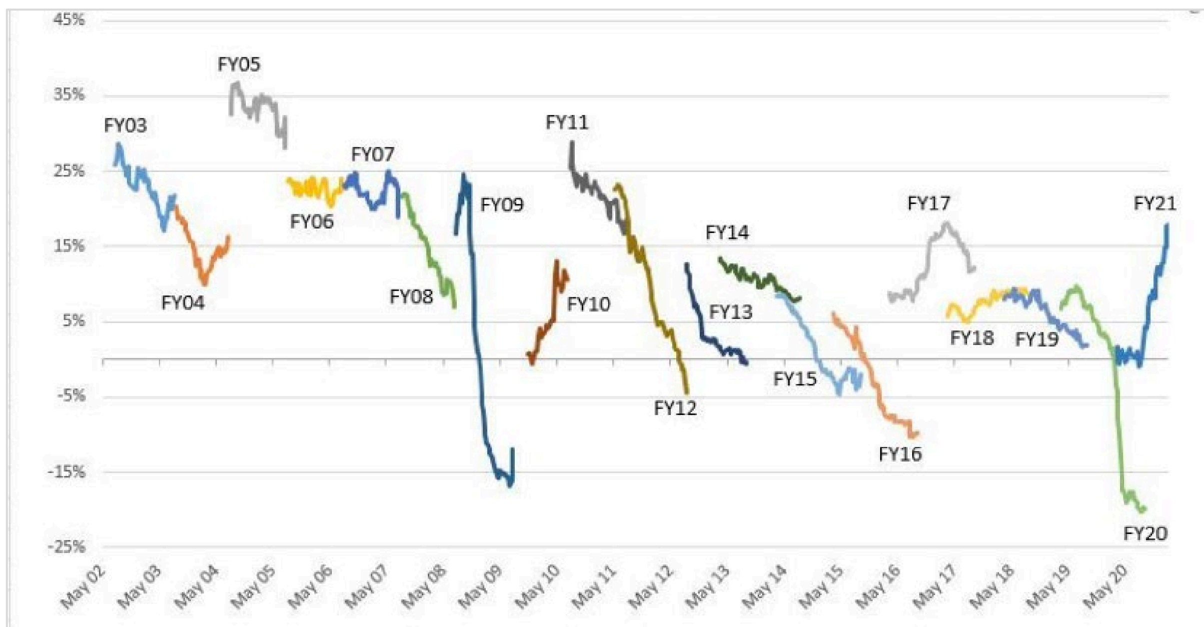
Source: Variant Perception, E&P Financial

While the RBA seems to think that inflation is running below historical levels and is not yet a concern, we are hearing otherwise. High freight costs and limited inventory are disrupting the demand / supply equilibrium. Wage pressure is emerging in several industries also. The inflationary fears are starting to be reflected in rising bond yields. It is a development worth monitoring.

Conclusion

The February reporting season highlighted plenty of reasons for optimism. In the main, Australian companies have navigated the challenges of COVID with innovation and a cost-conscious mindset. Earnings are recovering, often due to margin expansion rather than significantly higher revenues. Importantly, for the higher quality companies in the market the upgrade cycle in earnings continues. The following chart depicts the Earnings per Share forecasts of the Australian market. Generally, the market overestimates earnings every year and then gradually downgrades as the year rolls on. As the February reporting season unfolded, the earnings growth continued to move higher – typically a bullish sign. We continue to see reasons for optimism – the February reporting season reinforced our conviction.

Earnings per Share estimates – S&P / ASX 300



Source: Factset, Platypus, Macquarie Research

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