July 2021

Australian Equities

– Investment Themes and Sector Outlook

This information has been prepared by Northcape Capital, the underlying investment manager for Warakirri's Australian Equities funds.

Market Landscape

The last 12 months saw a sharp rebound in the ASX 200 index, as investors began to price in a strong cyclical recovery in activity and profits. The Reserve Bank added liquidity to the system while government support measures aided growth. Earnings forecasts were consistently upgraded over the year, supporting a 28% advance in the index (on a total return basis).

Forecasting was hazardous over the last year as evident from the following changes:

- The iron ore price more than doubled, rising from $101/tonne to 215/tonne.
- 10 year bond yields rallied strongly off a depressed base (0.9% to 1.5%).
- The gold price was relatively flat at US$1770/oz.
- The oil price rebounded from US$39 to US$75/bbl. as inventories declined and the supply/demand balance tightened.
- Corporate profits increased 27% (All sectors ex Resources +14%; Resource sector +61%).

We expect continued economic expansion in the year ahead but at a slowing pace. Some tailwinds from last year such as fiscal support and domestic tourism spending could become headwinds.

However distorted spending patterns last year contributed to a sharp rise in savings and this may limit any downside risk to growth.

Concerns regarding inflation have been a prominent theme in markets, with a particular focus on the US and supply bottlenecks in certain sectors. While this theme caused volatility in bond markets, we note that the 10-year bond rate remained below 2% for the entire year. In our view, a risk-free rate below 2% implies current equity valuations remain attractive. It is possible that inflation accelerates next year but the RBA currently expects to keep the cash rate at 0.1% until at least 2024 due to chronic low growth in wages.

A successful COVID vaccine rollout will be critical to the economic expansion forecast by many analysts. The rollout has been frustratingly slow to date but we expect a big improvement over the next six months. At this stage it appears around half the adult population could be vaccinated by September which would reduce the risk of transmission of the virus. Full vaccination (80%+ of the adult population) may be possible by end of this year. The opening of international borders is likely to begin in a phased manner within 12 months.

Our expectation is for a modest rise in the equity market in the year ahead, supported by a further rise in profits and continued low interest rates. Market consensus is for eps growth in the 12-15% range, with industrial sector profits accelerating and a smaller improvement in resource sector earnings. Operating leverage should be evident in FY 2022, although reversal of wage freezes and addition of some discretionary costs (previously slashed) will moderate gains.

We also expect the current elevated level of corporate activity to continue, supported by dislocations in operating conditions for some businesses, very low funding costs, and increasingly by pension funds seeking to take listed businesses private.

Investment Themes

Private/public market valuations

The equity market rotation toward cyclical exposures over the past 12 months has masked strong underlying demand for long duration assets (such as infrastructure) in unlisted markets. This demand is underpinned by an insufficient and finite supply of income producing assets to meet the growth in investible capital. This mismatch is particularly acute in Australia, given the compounding of accumulated superannuation balances combined with increasing mandatory contribution rates.

As a result, a significant gap has opened up between listed infrastructure valuations and multiples being paid in private transactions for assets with similar characteristics. The recently announced sell down of a minority stake in Telstra's tower assets and the unsolicited proposal to privatise Sydney Airport are manifestations of this trend.

We suspect the structural drivers behind this will persist into the medium term, resulting in an increase in proposals and transactions of this nature over time.

Our portfolio includes a number of listed businesses that feature free cash flow characteristics that are desirable to long term private investors. Absolute and relative multiples for this style of business are likely to expand over the medium term as a result.

Valuation bubbles

Another noted consequence of COVID has been the significant government response to stimulate economies through the initial economic shock. This has injected ample liquidity into markets, and combined with a surge in retail investor interest, has resulted in heightened valuations in some sections of the market. Indeed, we have seen several high profile examples offshore, including in meme stocks like Gamestop and AMC, as well as across other asset classes like cryptocurrency and NFTs where there has been extreme volatility and price movements that appear disconnected with fundamentals.

In our market, the tech sector has performed well (+39%) given this backdrop and the potential growth on offer but more extreme exuberance has largely been limited to a few pockets, including the buy now pay later sector. Despite these accommodative conditions, company specific developments, including a downgrading of growth expectations can quickly unravel valuation premiums as seen with former market darling Appen (APX -60%).

Resources

Commodity prices have benefitted from a synchronised global economic recovery cycle that is spurring industrial demand, coupled with supply challenges which have been exacerbated by severe COVID outbreaks in commodity producing regions, particularly South America.

These price increases have added meaningfully to the free cash flow generation of Australia's mining sector today. However, perhaps the more significant medium term positive driver of value for equity investors in this sector has been the ongoing investment spend discipline despite higher profits.

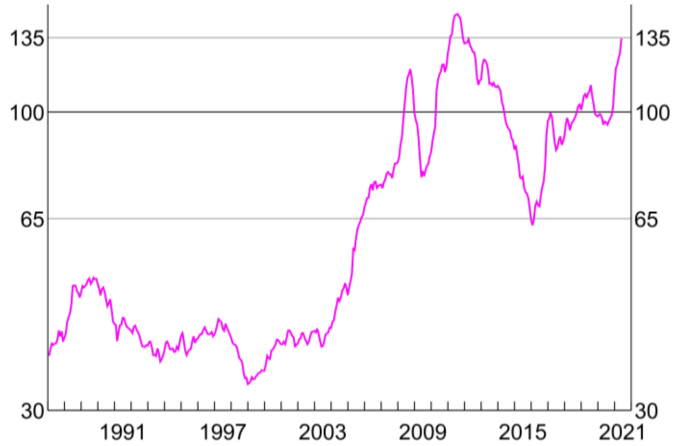
Historically, periods of high commodity prices induced a reckless increase in spending on growth projects, particularly at RIO and BHP. The more measured approach witnessed at present means that balance sheets are in excellent shape, and that the large miners will continue to generate significant free cash flow to shareholders, even at far lower commodity prices.

Energy

The oil price almost doubled in FY21 to finish the year at $75, about 15% higher than it was pre-COVID. Global demand recovered to within 5% of pre-pandemic levels and supply cuts by OPEC have balanced the market.

The energy sector did not perform as well as expected given this backdrop, rising by just 7%.

RBA Index of Commodity Prices
SDR, 2019/20 average – 100, log scale



Source: RBA

This performance is partly explained by the fact that long term oil price expectations moved by much less than spot prices, but we think rising ESG concerns may also have played a part. Energy companies globally are being forced to adapt their plans to fit with a transition to net zero emissions and we see little evidence of progress on this front from the Australian producers, who are all targeting substantial production growth over the next five years.

We expect corporate strategies to evolve over the coming years to place more emphasis on shareholder returns and less on investment in production growth.

Healthcare

In the Healthcare space, the widespread, global deployment of COVID-19 vaccines since the beginning of 2021 has seen a pullback in cyclical-COVID 'winners', e.g. Sonic (SHL), Ansell (ANN), and a significant re-rating in cyclical-COVID 'losers', e.g. Cochlear (COH); ResMed (RMD).

At the same time, structural winners from the pandemic have clearly emerged. We believe Fisher and Paykel (FPH) remains a long-term beneficiary of the rapid and significant surge in demand for its products during COVID as more physicians are now trained and familiar with the use of its leading high-flow therapies. The resultant 60%+ lift in its installed base during FY21 compared to before the pandemic has also boosted sales of its high-margin Consumables products, which are expected to remain significantly above historic levels even as the pandemic subsides.

Cochlear (COH) has continued to gain share from competitor Advanced Bionics' recall of faulty implants despite the recall starting almost 18 months ago. This highlights a structural change in the market as patients and physicians have noted a preference for Cochlear implants due to their strong reliability. We believe this cements COH as being the best positioned out of its peers to increase its share of the underpenetrated adult and seniors developed markets (currently only 3% penetrated).

Over the past year, Cochlear has taken advantage of its stronger position and the rapid recovery of elective surgeries around the world by launching 7 new products/enhancements in the last 12 months.

The impact from lower plasma collections in the US last year (down ~20%) was not yet apparent at CSL's half year results due to the 9-month lag in the plasma production cycle. While collections have continued to improve since their lows in April this year, they remain below pre-pandemic levels. We expect the ongoing supply issues and higher donor fees to result in a fair flat profit for at least another 12 months before the company resumes more normalised growth.

Whilst COVID-19 testing volumes have significantly declined from their peak in 2020, surges in COVID-19 cases around the world has meant Sonic (SHL) has continued to be a COVID beneficiary so far in 2021. However, we expect the short-term boost to earnings from its higher testing fees and volumes to revert to more normal levels as COVID becomes endemic over time, i.e. more akin to the flu.

Whilst Sonic has emerged from the pandemic with a strengthened balance sheet, management has indicated it plans to use its significant cash inflow for deleverage/acquisition purposes, rather than returning cash to shareholders.

Looking forward, the cyclical-COVID winners will likely continue to be resilient for longer, in part caused by slower-than-expected deployment of vaccines and new virulent strains. However, with estimates the global adult population will be 80% vaccinated by the end of 2021 at the current pace, we see continued outperformance for these names as likely limited over the next 12 months.

REITs

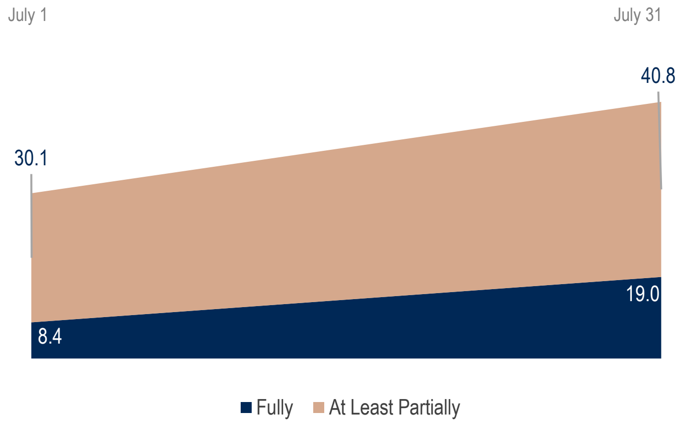
REITs slightly outperformed the broader market last year, although performance was heavily weighted to the fund managers Charter Hall and Goodman Group and those with residential development exposure. Conversely, the passive REIT's where income streams are more biased to rent collection in the retail and office sectors underperformed.

Asset valuations in office and retail held steady despite rents being under structural pressure. Institutional investors (and valuers) have adopted lower hurdle rates for investment over the last year, which has more than offset the impact of lower rental income.

We remain cautious on office and retail REITs as structural factors may continue to constrain performance. The shift to hybrid work could see lower demand for office space from large corporates resulting in vacancy rates edging higher and downward pressure on office rents.

Increased supply of office space in Sydney from 2024 may also limit rental growth. A gap between market and contractual rents in the retail sector has widened and will likely lead to a downward adjustment in rents as leases are rolled over. The increasing proportion of retail sales transacted on-line is limiting retailer profitability and the ability of tenants to afford high rents.

People Vaccinated - Australia (%)



Source: Australian Commonwealth Government

A continued structural shift to on-line sales is supporting solid demand for warehouse space, particularly in inner city locations. Large scale tenants are seeking longer term leases (15 years+) because of high levels of investment required in their warehouses.

Institutional investors are attracted to the high quality income streams from these assets, resulting in cap rate compression. This is a global thematic and should continue over the year ahead, supported by low long term interest rates.

Retail

The impacts of the pandemic have resulted in significant volatility in retail sales, though underlying sales levels have remained robust in aggregate and above long-term trend levels. The lack of ability to spend on travel coupled with increasing employment levels gave consumers the opportunity and ability to continue spending on domestic retail at a high pace.

The year was characterised by a change in leadership as growth in staple areas such as supermarkets and other COVID beneficiaries began to slow and the baton was passed to more discretionary areas emerging for lockdowns.

In general, the Australian listed retailers have managed their businesses well during unprecedented and trying times, coping with in some cases temporary store closures, in others extreme levels of demand which placed huge pressure on supply chains and the obvious explosion in on-line spending.

The longer-term winners out of this environment we believe are those retailers that have provided customer satisfaction through product availability and ease of shopping. They have needed to invest capital to improve their operations, not just on-line but in store and throughout their supply chains.

While this may have hindered short-term margins, the longer-term benefits operationally and in the enhancement of their customer perception, brand loyalty and trust will drive future returns.

Looking further forward we will be engaging with retail companies on their embracing of related social issues to further strengthen their brands much like as the better retailers have led on environmentally friendly packaging.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au