

# Wealth Update

*Winter 2024*



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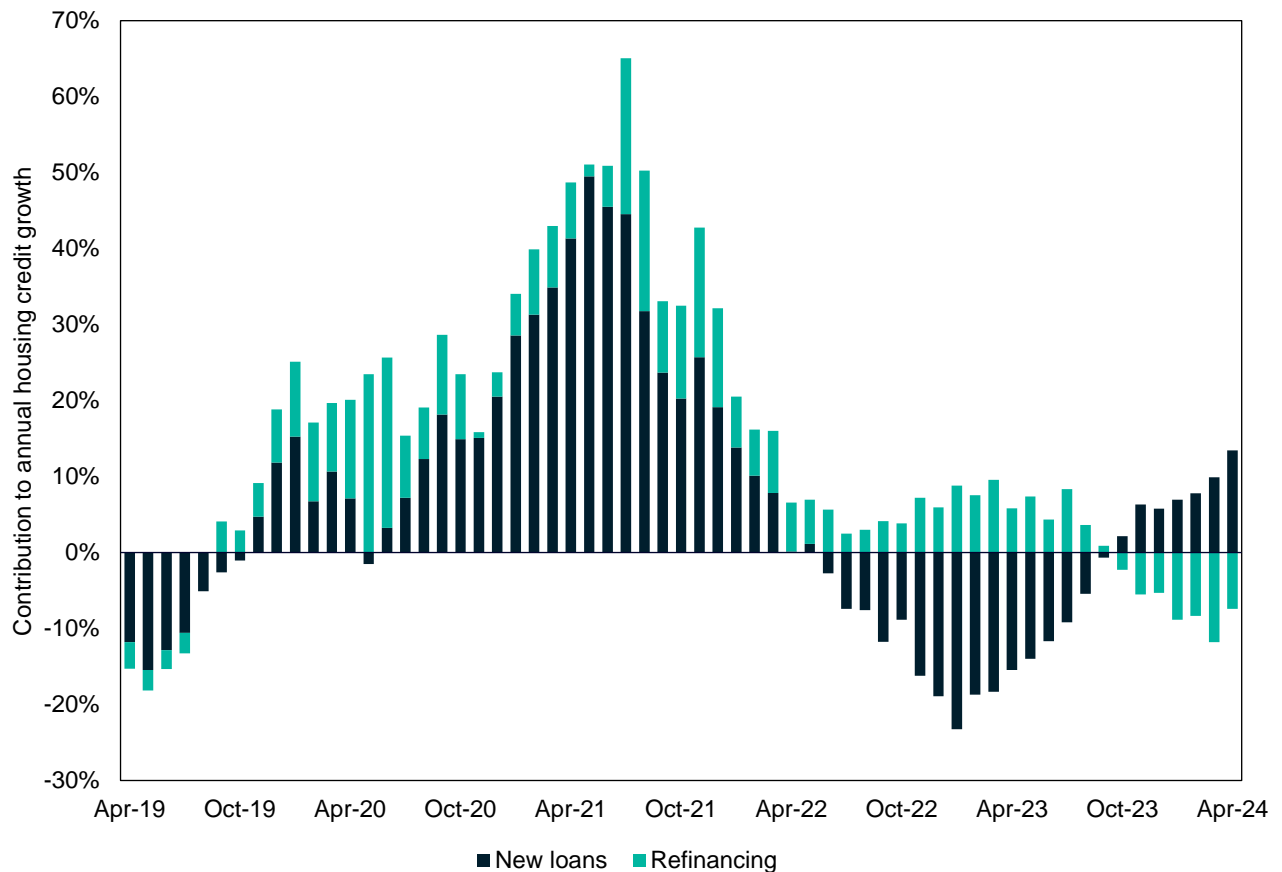
## Australian banking sector update

All major banks have now provided first half results for FY24 that offers some insight into current performance. The following article highlights key drivers of bank earnings and offers our near-term outlook for the sector. Our focus is on the major “Big Four” banks comprising Commonwealth Bank (CBA), Westpac (WBC), National Australia Bank (NAB) and ANZ Group (ANZ).

### Credit growth

New loan creation has substantially picked up after decelerating over the course of 2022 and early 2023. This follows a surge in refinancing activity (in **green**) as households sought more attractive mortgage rates, with finances under pressure in the current, higher interest rate environment. It was also triggered by the expiry of cheaper, fixed rates offered under the Reserve Bank (RBA) Term Funding Facility (TFF). Since late 2023, we have seen the rental crisis<sup>1</sup> and strong population growth<sup>2</sup> (driven largely by net migration), trigger increased growth in new lending as more individuals entered the housing market.

### Annual housing loan growth split by type and contribution (Apr-19 to Apr-24)



Source: ABS, PPWM calculations.

<sup>1</sup> C. Withers, 'Rental affordability in Australia is as bad as it has ever been, according to new Anglicare Australia report', *ABC News* (23 April 2024), <https://www.abc.net.au/news/2024-04-23/anglicare-australia-rental-affordability-report/103754274>, (accessed 10 June 2024).





<sup>2</sup> 'Australia's population grows by 2.5%', *Australian Bureau of Statistics* (21 March 2023), <https://www.abs.gov.au/media-centre/media-releases/australias-population-grows-25>, (accessed 10 June 2024).



Credit growth is expected to soften on balance due to headwinds posed by elevated interest rate conditions, as well as the prospect of weaker population growth. Mooted immigration caps<sup>3</sup> would reduce the need for credit in aggregate, as fewer people demand goods and services funded by borrowing. One tailwind that could be supportive in the near-term is the extent of government support for first home buyers with new schemes and grants at a state level e.g. Queensland increasing the first home buyer stamp duty concession threshold to \$700k<sup>4</sup>.

## Credit quality

The underwriting for loans issued in recent years appears to be holding strongly. Arrears have either ticked lower or remained subdued depending on the lender, remaining below pre-pandemic levels. This is despite the challenge of higher interest rates making loan repayments more expensive.

90+ days of delinquency	1H23	2H23	1H24	Recent trend
Commonwealth Bank (CBA)	0.61%	0.47%	0.52%	
Westpac (WBC)	0.88%	0.75%	0.73%	
ANZ Group (ANZ)	0.70%	0.60%	0.60%	
National Australia Bank (NAB)	0.75%	0.66%	0.66%	

Source: Company filings; CBA reporting is off-cycle so 1H24 is six months to Dec-23 whereas it is six months to Sep-23 for other majors.

A factor that has supported this outcome has been the strength of household balance sheets following elevated levels of government stimulus during the pandemic. A declining savings rate, now 0.9% as of March 2024, suggests this impulse is abating in aggregate.

The larger support has undoubtedly been the strength of the labour market with unemployment remaining well below the 5%+ levels seen in the pre-pandemic period. Maintaining employment at these levels has supported household debt repayments and reduced the propensity of loans to be impaired. However, we are observing a more challenging backdrop going forward with unemployment expected to rise despite economic growth picking up in 2025. This could lead to reduced household ability to repay mortgages as well as weaker business performance due to lower demand. Consequently, we could lead to headwinds for both household and business loan quality.

<sup>3</sup> C. Cassidy, 'Labor's international student cap an 'unprecedented' overreach and 'recipe for chaos', experts warn', *Guardian Australia* (23 May 2024), <https://www.theguardian.com/australia-news/article/2024/may/23/labors-international-student-cap-an-unprecedented-overreach-and-recipe-for-chaos-experts-warn>, (accessed 10 June 2024).

<sup>4</sup> B. Cooper, 'Stamp duty threshold hiked: Is Queensland the new top choice for first home buyers?', *your mortgage* (10 June 2024), <https://www.yourmortgage.com.au/mortgage-news/queensland-stamp-duty-threshold-hiked>, (accessed 10 June 2024).

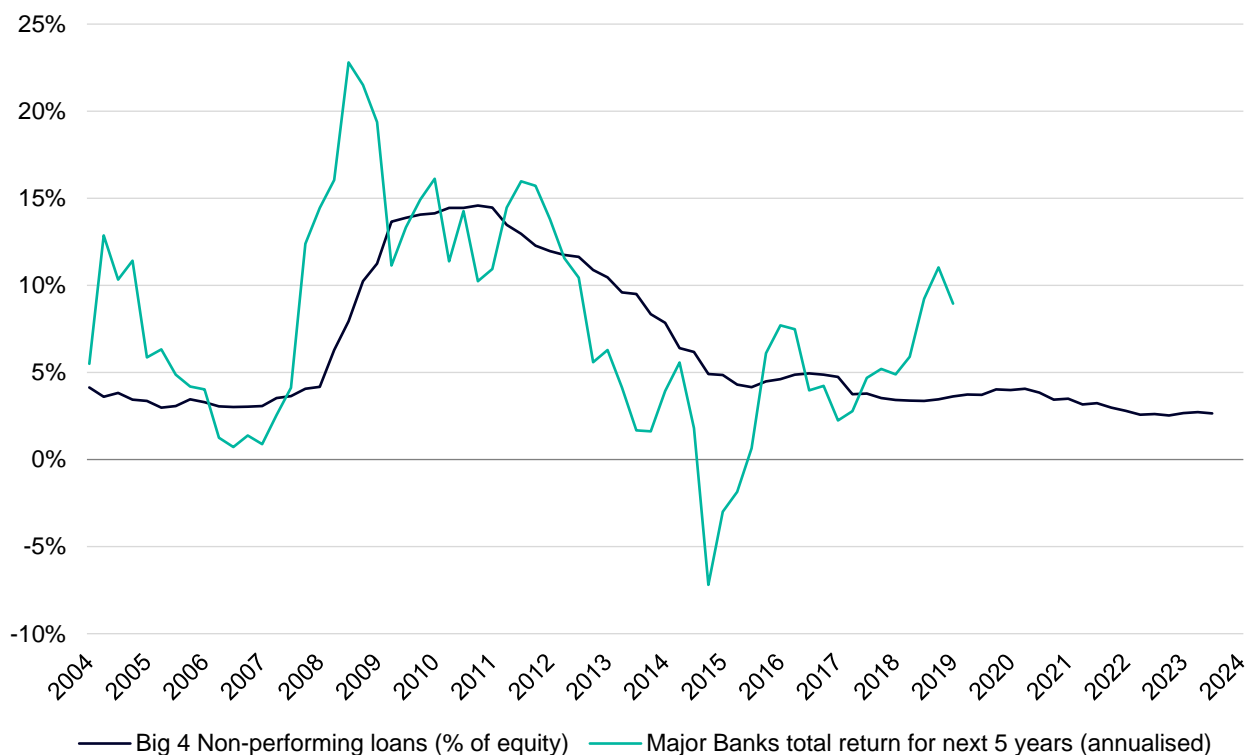


Metric	Australia	
	2024	2025
Growth	1.3%	2.2%
Inflation	3.4%	2.8%
Interest rates	4.2%	3.4%
Unemployment rate	4.2%	4.5%

Source: Bloomberg consensus as of 10 June 2024.

To emphasise this point we see the historical pattern of impaired loans as a proportion of major bank equity. This is contrasted against the return of banks for the next 5 years. As you can see bank shares (the **green line**) tend to perform best **after** periods of distress (when loan impairments are rising), as opposed to periods where distress is low. The current run is well-ahead of past experience and illustrates just how far prices have gone relative to fundamental performance.

#### Non-performing loans as proportion of equity versus Major Bank index returns (Jun-04 to Jun-24)



Source: Bloomberg.

In summary, current credit metrics have remained positive thanks to the strength of the labour market. The outlook is more mixed with some likely deterioration as unemployment worsens. Leading indicators of labour market demand such as job vacancies and business capacity utilisation also point to near-term weakness. It remains reasonable, in our view, to expect more provisioning to be required which will detract from bank earnings and dividend growth.



## Net interest margin trends

Net interest margin refers to the spread between the income received on loans made by a bank versus the cost of the funds it borrows to make these loans. This is a key measure of bank profitability. In recent years with higher interest rates, bank profitability has been flattered by lower than usual financing costs. These include TFF funding (which is due to expire by 30 June 2024) as well as delays in passing on higher rates to retail customers.

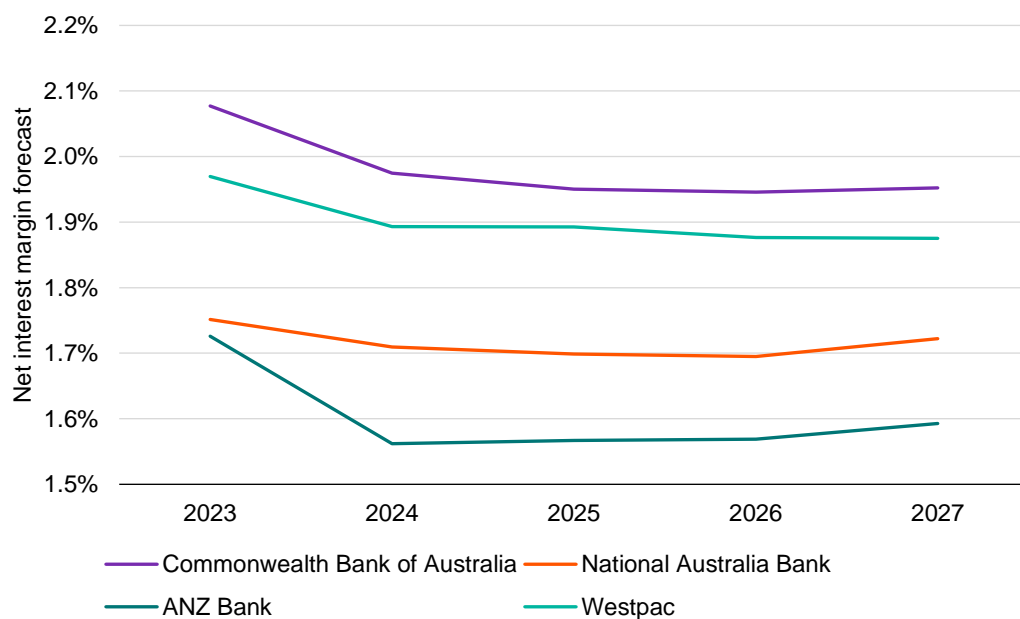
These tailwinds have shown signs of abating with a mix of competition for deposits and new mortgages as well as the expiration of the TFF all contributing to weakening margins as shown below.

Net Interest Margin	1H23	2H23	1H24	Recent trend
CBA	2.14%	2.16%	2.12%	↓
WBC	2.13%	2.11%	2.06%	↓
ANZ	2.01%	2.00%	1.86%	↓
NAB	1.71%	1.64%	1.64%	↓

Source: Bloomberg.

The recent trend is not expected to abate as shown below with the latest consensus forecasts. Competition for mortgages may also be exacerbated if the RBA reduces interest rates, as a lower rate environment reduces the gap between market-based financing costs and borrowing from retail customers. In that scenario, non-bank lenders have more flexibility to offer loans and can price more competitively against the majors. This would reduce the income generated on mortgages and exert downward pressure on net interest margins ("NIMs") consequently.

### Forecast Net Interest Margins (FY23 to FY27)



Source: Bloomberg.



In summary, while net interest margins improved in recent years this trend appears to have reversed and is expected to see lower NIMs over the near term (recovery in FY27 for some). This is a net headwind to bank profitability and should result in lower earnings and dividends to shareholders as a result.

### Operational efficiency (cost to income)

Efficiency ratios measure the proportion of operating costs relative to revenues and other income. Reducing these can be an important driver of higher profits and payouts to investors via buybacks and franked dividends.

These ratios have been volatile depending on certain one-off provisions such as regulatory fines or redundancy costs from business restructuring. This has helped drive improvement in the majority over the past half-year as shown below.

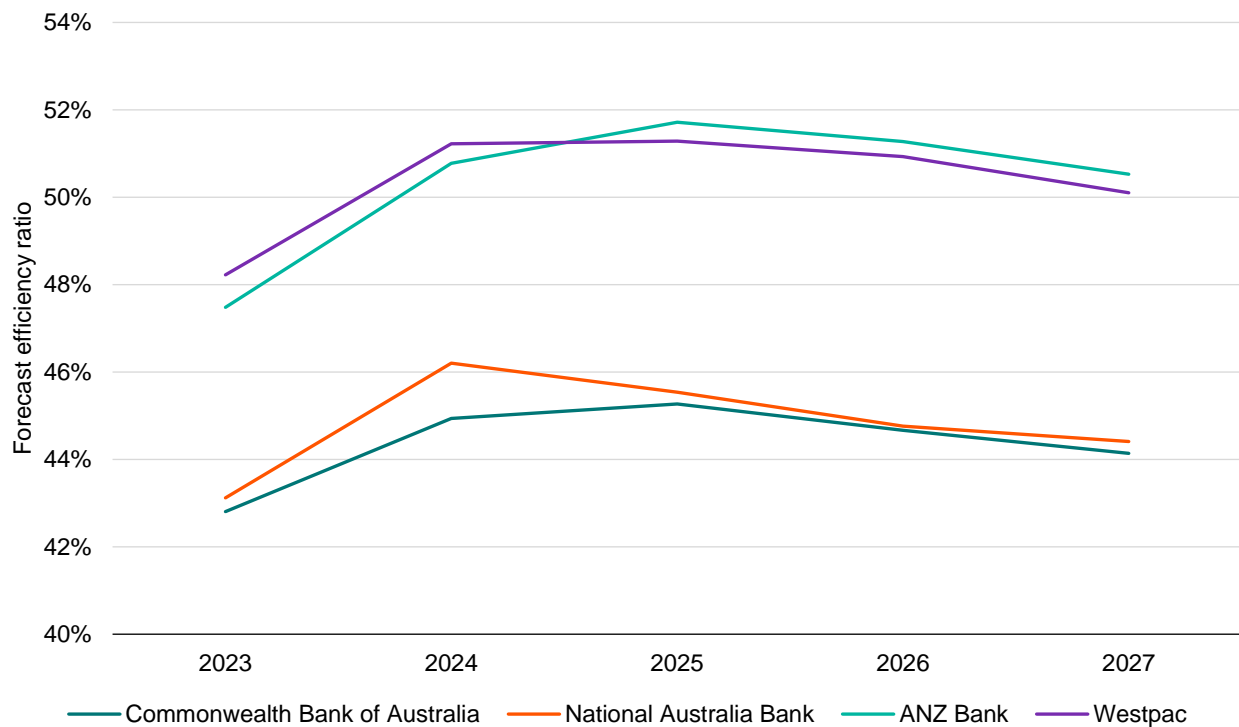
Cost to income	1H23	2H23	1H24	Recent trend
CBA	41.7%	44.1%	43.8%	↓
WBC	45.3%	53.6%	50.9%	↓
ANZ	52.3%	47.7%	54.4%	↑
NAB	41.3%	45.7%	45.6%	—

Source: Bloomberg.

The current outlook from consensus forecasts suggests some scope for limited optimism with efficiency ratios expected to decline after peaking in 2024 or 2025 (depending on the lender). The scope of improvement appears relatively limited, however, with only 1-2% uplift to profit margins being anticipated. Even then business operations are still expected to remain above 2023 levels. There is potential for downside risk to the consensus view if the majors encounter large spending imposts e.g. more investment spending required to upgrade outdated technology to improve the banking offering.



## Forecast Efficiency Ratios (FY23 to FY27)



Source: Bloomberg.

The key point remains that this is an avenue where material improvement is not expected to ensue. It remains an area we continue to monitor however we only expect to be a slight tailwind for the sector provided no further downside risks emerge.

## Valuation

The major banks have enjoyed a strong start to the year with sizeable buying amongst investors in aggregate. This has seen valuations become stretched against history. Examining price to earnings (P/E) ratios suggests all are trading expensive versus the long-term average, the question is degree. CBA is one of the more egregious examples with the share price needing to fall over 36% to align with its longer-term average valuation. While the bank retains a clear lead in its retail franchise and strong gains as the number two in business banking this valuation is difficult to justify given the limited growth prospects in the near term.

Bank	P/E Ratio	Move required to reach long-term average
CBA	22.2x	-36.2%
WBC	14.2x	-14.6%
ANZ	13.0x	-11.8%
NAB	15.5x	-25.1%

Source: Bloomberg, long-term average calculated from early 2005 to Jun-24.

On price to book (P/B) ratios there is arguably some scope for optimism with both ANZ and Westpac trading reasonably below their longer-term average. This reflects in part their return on these assets with NAB and CBA expected to earn low teen returns on equity versus sub-10% for the latter pair.





Bank	P/B Ratio	Move required to reach long-term average
CBA	2.8x	-22.5%
WBC	1.3x	+30.5%
ANZ	1.2x	+20.5%
NAB	1.7x	-13.4%

Source: Bloomberg, long-term average calculated from early 2005 to Jun-24.

Overall we would assess valuation as a net negative for the sector. There is a clear need for earnings improvement to justify recent price action but the latest consensus figures suggest this will not be forthcoming in the near term. Current pricing would suggest being underweight until we see a meaningful improvement in the outlook or price weakness.

## Outlook

**Credit growth** has continued to climb with an influx of immigration and overall population growth at multi-decade highs. There are prospects for this slowing however, with expectations of both higher unemployment and weaker migration, the latter following planned cuts to student migration.

Meanwhile **credit quality** has risks to the downside in the near-term, given unemployment is expected to rise and there is an elevated risk of higher credit provisioning required after a period of low arrears.

Key profitability drivers include weakening **net interest margins**, implying lower overall profitability and therefore reduced dividends to shareholders over the medium term. Meanwhile, **operational efficiency** improvements appear on track in the consensus outlook but are expected to be marginal and unlikely to shift the outlook.

Finally on **valuations**, this is no longer just a company-specific problem. The degree of the share price rally in the sector to start 2024 has seen all the majors become expensive on an absolute basis relative to history. CBA is still a standout in the level of its premium to peers and internationally we hasten to add. Given the anaemic earnings outlook this remains untenable in our view and we need to see sizeable share price weakness to warrant a more constructive view on the sector.

In summary, headwinds remain in place with weaker profitability and expensive valuations decisive over tailwinds in credit growth and efficiency improvements. Another tailwind in the immediate term will be the return of excess capital via share buybacks which will add buying pressure but is unlikely to be sustained. On a longer-term outlook however, current prices remain excessively optimistic with valuations stretched and warrant maintaining an underweight position.

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## Reporting season update

### International equity portfolio

#### Abbott Laboratories (ABT: US)<sup>5</sup>

Share price	10/6/24: US\$107.49
Result	Q1 FY24
Underlying Revenue	\$US9.96b, up 10.8% on the pcp excluding COVID-19 tests.
Underlying EPS	\$US0.98, down 4.9% on the pcp.
Key points	<ul style="list-style-type: none"><li>Abbott reported a strong set of results to begin 2024 with both sales and profits coming in ahead of expectations by 0.8% and 3.2% respectively. In addition, management raised guidance for full-year earnings per share by 0.5% from US\$4.60 per share to US\$4.625 per share. A disappointing aspect of the upgraded earnings forecast was the reluctance to raise the top-end of guidance in line with the strong overall start to 2024.</li><li>A key driver of the result was the continued strength in sales of its medical devices which were 3.5% above consensus expectations. This space continues to benefit from a backlog in medical procedures deferred during the pandemic.</li><li>After the earnings release the company was subjected to a Class I recall by the US Food and Drug Administration (FDA). This impacted its HeartMate3 device which is a critical stopgap for patients dealing with heart failure. The FDA response was triggered by reports of 70 injuries and two deaths raising fears over possible legal action for product defects. Abbott dominates this space with over 99% of market share<sup>6</sup> although this is small in the context of the broader group with total sales of US\$800m amounting to ~2% of total Abbott revenues.</li><li>In addition, there are fears over the potential cost of legal action alleging deficiencies in warnings over cow's milk-based baby formula products. This follows a \$60m jury award against rival Reckitt Benckiser in Illinois on March 13. Bloomberg Intelligence estimates potential costs of US\$0.75b to US\$3b with Abbott anticipated to face 55% of these losses based on its market share<sup>7</sup>. This process could drag on for several years with an appeal on the initial jury decision unlikely to be held until 2026 for example.</li></ul>
Our comments	<ul style="list-style-type: none"><li>The potential for litigation overhang is real in the near term. Market dominance in the HeartMate3 niche should continue to preserve earnings but may raise the risk of new entrants to undermine its position. The baby formula saga may take several years before it is ultimately resolved and weigh on the share price until investors have more clarity.</li><li>The core Abbott business is continuing to perform well. The disappointment of market participants over a failure to upgrade guidance should, arguably, fade provided the company continues to execute well in its core products and exceed investor expectations. FDA approvals for new devices illustrates the continued innovation within the business that should underpin strong sales and profit growth going forward.</li></ul>

<sup>5</sup> All figures in USD unless otherwise stated. Results referring to percentage changes (increases/decreases) relate to the previous corresponding period (pcp) e.g. Q4 FY24 results are compared to those of Q4 FY24.

<sup>6</sup> 'Abbott's recall of HeartMate Touch System may impact LVAD market sales, says GlobalData', *GlobalData* (15 March 2024), <https://www.globaldata.com/media/medical-devices/abbotts-recall-heartmate-touch-system-may-impact-lvad-market-sales-says-globaldata/>, (accessed 10 June 2024).



## Adobe (ADBE: US)<sup>5</sup>

Share price	10/6/24: US\$459.94
Result	Q1 FY24
Revenue	\$US5.18b, up 11% on the pcip.
Underlying EPS	\$US4.48, an increase of 17.9% on the pcip.
Key points	<ul style="list-style-type: none"><li>• Adobe saw a strong start to 2024 with both revenue and earnings per share ahead of consensus forecasts by 0.8% and 2.3% respectively.</li><li>• Revenue guidance for the second quarter came in slightly below analyst estimates at US\$5.275b vs US\$5.31b. This arguably contributed to weakness in the share price following the announcement as it fed into fears of insufficient monetisation in its new artificial intelligence (AI)-related product suite.</li><li>• Management announced a new US\$25b share buyback program (up to 12.5% of the current market value of the business) through to March 2028. This should reduce the impact of dilution from share issuance as well as support the share price over this period.</li><li>• The company will pay a US\$1b termination fee to software firm Figma following its failed acquisition efforts due to strong opposition from regulators. It is disappointing that the sale did not proceed given Figma's potential to entrench Adobe's solutions in the broader market. The funds could, however, be used to support further share buybacks to improve shareholder returns.</li><li>• The rise of other AI-powered solutions for digital media such as OpenAI's Sora (this allows for the creation of video clips for example via text prompts) continues to concern investors particularly for fears of the longer-term growth prospects of the business. Management was at pains to note, however, that they see the advent of new tools as a "win-win" proposition. To their logic the growth of digital content will mean even more work in editing is required which will support demand for Adobe solutions where they have an edge.</li></ul>
Our comments	<ul style="list-style-type: none"><li>• Adobe continues to be one of the more volatile stocks in the portfolio. Investor sentiment ebbs and flows wildly due to concerns and optimism about the potential for AI solutions and the implications for the future of the business.</li><li>• In the near term however, the business trajectory is continuing to perform well on a mix of adding new customers and increased pricing as it continues to innovate its product suite.</li><li>• The failed Figma acquisition is a disappointment in a sense but the renewed customer focus on product innovation particularly in AI is setting the stage for future growth and the onus is on Adobe management to capitalise.</li><li>• Overall, we expect the business to continue seeing earnings expansion in the low-teens. The concerns over future competition bear watching but have seen negligible impact on the business to date. We will continue to monitor this as a key risk however.</li></ul>

<sup>7</sup> 'BI Litigation Watch: Baby Formula NEC Litigation', *Bloomberg Intelligence* (20 May 2024), <https://blinks.bloomberg.com/screens/DOCV%20RES%20SDSBA2DWLU68>, (accessed 10 June 2024).



## Aena SME SA (AENA: EU)<sup>8</sup>

Share price	10/6/24: €181.10
Result	Q1 FY24
Revenue	€1.233b, up 20.1% on the pcg.
Underlying EBITDA	€581.1m, an increase of 57.7% compared to the pcg.
Key points	<ul style="list-style-type: none"><li>• Revenues were boosted by the consolidation of its Brazilian airport acquisitions which increased revenue by €44.1m and EBITDA by €25.3m. Excluding this impact, revenue rose 15.8% and EBITDA was up by 50.8%.</li><li>• Revenue growth was supported by the ongoing recovery in passenger volumes. Overall passenger traffic was up strongly with 11.9% growth on the pcg to 74.6m across the Group. In its core operations within Spain the increase was even stronger at 13.2% to 60.8m passengers.</li><li>• Revenue growth was also broad-based with the commercial business seeing an increase of 19.4% and the aeronautical business, up 21% on the pcg.</li><li>• Expense growth was modest vs the pcg, rising only 2.9% on the pcg thanks to lower energy costs (down 25.4% in Spain). Excluding this impact expense growth was 5.6% on the pcg, still dwarfed vastly by the 20.1% expansion in headline revenue.</li><li>• Management continues to guide towards strong near-term growth in passenger volumes with growth outpacing other airport operators and anticipating it will manage around 1m people per day by 2026 across all its terminals.</li></ul>
Our comments	<ul style="list-style-type: none"><li>• The quality of the AENA portfolio remains intact in our view with the group continuing to execute well and consumer demand for travel remaining intact.</li><li>• AENA shares trade at a relatively undemanding valuation given its asset base (15x 2024 consensus EPS and dividend yield of 5.2%).</li><li>• The combination of steady dividend and reasonable earnings growth should continue to see the stock perform well over the near term.</li><li>• One area of concern going forward given their growth ambitions for international expansion, will be ensuring that the business does not overpay on acquisitions. This will be an area we monitor closely as poor decisions could lead to weaker profitability.</li></ul>

<sup>8</sup> Company Transcripts, Reuters and Bloomberg



## Amazon.Com Inc (AMZN: US)<sup>5</sup>

Share price	10/6/24: US\$187.06
Result	Q1 FY24
Revenue	\$US143.3b, up 13% on the pcp.
Operating Income	\$US15.3b, an increase of 221% on the pcp.
Key points	<ul style="list-style-type: none"> <li>• Amazon had a strong start to 2024 with positive performance across all major divisions. Amazon Web Services (AWS) was a key driver with it reaching an annualised revenue run rate of over US\$100b according to CEO Andy Jassy.</li> <li>• AWS saw sales up 17% for the year to March, 2% ahead of consensus figures and marking a re-acceleration in growth, up from 13% seen in the December quarter. This coincided with higher profitability with margins expanding from 30% in the December quarter to 38%. Similar to peers, Amazon executives noted reduced emphasis on cost-optimisation amongst its client base which is viewed as supportive for ongoing strength in AWS revenue growth.</li> <li>• Cost cutting (over 27,000 staff laid off since late 2022) and increased utilisation of its logistics services helped drive further profitability in its ecommerce operations with the international division seeing a return to profitability, something only previously experienced during the height of pandemic lockdown restrictions.</li> <li>• Advertising remains an important driver of profitability with its true impact remaining obscured given a reluctance to disclose the margins from advertising. That being said we can see its impact in revenue with Advertising sales up 24% for the year to March excluding currency impact. By contrast the broader business excluding Advertising and AWS saw revenue growth of a much slower but still impressive 10%. This has coincided with a recovery in profitability for the business excluding AWS to a peak last seen at the height of the pandemic. This is despite a shift in consumer spending away from goods towards services. It implies ad spending is contributing meaningfully to the bottom line.</li> <li>• Advertising is also being expanded with Amazon emulating streaming giant Netflix with the offering of an ad-supported Prime Video at a lower cost to households.</li> <li>• Similar to other tech peers, the company flagged an expansion in capital spending to take advantage of demand for both cloud productions and AI-powered solutions amongst its customer base with last year's US\$48.4b expected to be materially exceeded in 2024.</li> <li>• Finally, unlike their peers Amazon has thus far avoided declaring either an initial dividend or share buyback program instead choosing to build its cash pile, now over US\$70b as of March. Said cash pile offers flexibility to either reinvest in the business via capital spending or return capital to shareholders.</li> </ul>
Our comments	<ul style="list-style-type: none"> <li>• In our view this marked a strong result for Amazon with all divisions firing to start 2024.</li> <li>• The resumption of accelerating growth in AWS coupled with higher profitability was welcome in reinforcing the growth story at Amazon. In addition, it also highlighted the potential returns on investment from its reinvestment spending which will be important to maintaining its current valuation.</li> <li>• Overall, we are content with the business trajectory and leadership under CEO Jassy who, thus far, has taken the reins from founder Jeff Bezos and executed admirably.</li> </ul>



## American Water Works (AWK: US)<sup>5</sup>

<b>Share price</b>	10/6/24: US\$128.56
<b>Result</b>	Q1 FY24
<b>Revenue</b>	\$US1.01b, up 7.8% on the pcip.
<b>Underlying EPS</b>	\$US0.95, an increase of 4.4% on the pcip.
<b>Key points</b>	<ul style="list-style-type: none"> <li>Earnings growth was slightly weaker than consensus with higher rate filings being offset by increased financing costs as the company issued US\$1.4b in new debt (at 10-year and 30-year tenors).</li> <li>Earnings are still expected to reach management's guidance for 8% growth with the September-March period historically weaker for water demand due to colder weather.</li> <li>The company deployed a further US\$0.7b in a mix of infrastructure improvements and acquisitions during the quarter with over US\$0.5b in acquisitions currently under agreement. For the full year management expects US\$3.1b in capital investments (including acquisitions).</li> <li>The company affirmed its long-term earnings and dividend growth target of 7-9% with the 2024 full-year dividend expected to grow 8%.</li> <li>Concerns over new regulations by the US Environmental Protection Agency (EPA) appear to be largely unfounded. The company indicated it anticipated no changes to either capital spending requirements or operating costs as a result of the new regulations which have a five-year period until compliance is required (by 2029).</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>American Water Works continues to execute well in achieving high single-digit growth in earnings notwithstanding notable headwinds such as higher interest rates.</li> <li>The company appears to be tracking well against its longer-term ambitions and the removal of EPA regulation risk is supportive of near-term fundamentals as well with some investors fearing a material implementation cost.</li> <li>Overall, we expect the company's steady, high-single digit growth coupled with a growing dividend to see stronger returns going forward following the recent de-rating in the share price. One catalyst could be a decline in interest rates if these decline in line with consensus forecasts.</li> </ul>



## Vinci (DG: EU)<sup>5</sup>

Share price	10/6/24: €104.80
Result	Q1 FY24
Revenue	€15.7b, up 4.8% on the pcg.
Key points	<ul style="list-style-type: none"> <li>Operating revenue growth was broad-based and led by the International businesses up 5.4% versus 4.1% for its French franchise.</li> <li>Passenger numbers at its airports continued to recover with 12.4% growth on the pcg. They were also 0.6% above levels last seen in 2019 prior to the coronavirus pandemic, this was the second consecutive quarter to achieve this outcome suggesting the recovery is well underway.</li> <li>The Group order book continues to climb meaningfully across its Cobra IS and Energies divisions, with even the Construction division seeing good renewal rates. It reached a new, all-time high of €66.7b marking 11% growth for the year.</li> <li>This should continue to give sizeable visibility on revenue growth in the near-term with the current bookings consistent with almost 14 months of average business activity. This ensures divisions that are ordinarily more cyclical in performance should be better placed to weather economic weakness compared to past episodes.</li> <li>Vinci Immobilier, its French real estate development business continued to struggle with revenue down 16% on the pcg as higher interest rates weigh on end-customer demand. The expectation of interest rate cuts by the European Central Bank later this year should be a support towards eventual recovery.</li> <li>Finally, the French toll roads business saw a weaker start to the year following farmer blockade activity that saw traffic decline in January and February before eventually recovering. This is not expected to be material enough to affect guidance. The Group is separately pursuing legal action against a proposed tax increase targeting toll road operators.</li> </ul>
Our comments	<ul style="list-style-type: none"> <li>Our overall view on the business remains intact with steady demand in its toll roads and airport business supported by secular forces (notably the energy transition) underpinning its other more cyclical divisions. The diversified nature of the conglomerate ensures growth continues even with some segments underperforming and we are pleased to see this steady growth continues to be the case.</li> <li>The company continues to trade at an undemanding valuation with a free cashflow yield of over 8% and a 2024 estimated dividend yield of over 4.8%. These factors coupled with mid to high single digit earnings growth should backstop investor returns strongly going forward.</li> <li>The lack of update on the French tax situation remains a lingering concern as it poses a near-term hit to profits if implemented in its current form. We believe the business has strong grounds for opposition and should ultimately either see the tax abrogated or some form of compensation offered. This is consistent with the view articulated by management as well as peers in this sector such as ASX-listed Atlas Alteria (ALX).</li> <li>We also note the recent snap election announced by President Macron for late June is triggering electoral uncertainty within France. This potentially has implications for Vinci's toll road concessions and other French operations and may lead to further share price volatility in the near term until the political picture is clearer.</li> </ul>





## Alphabet Inc. (GOOGL: US)<sup>5</sup>

Share price	10/6/24: US\$175.01
Result	Q1 FY24
Revenue	\$US80.5b, up 15% on the pcg.
Underlying EPS	\$US1.89, an increase of 61.5% on the pcg.
Key points	<ul style="list-style-type: none"> <li>Alphabet saw a strong start to 2024 with a combination of revenue growth and margin expansion. The growth in EPS is somewhat misleading due to this figure incorporating a strong gain on equity securities held by the company (worth US\$0.15 per share). Excluding this one-off item, EPS was US\$1.74 and up by a still strong 48.7% on the pcg.</li> <li>Sales growth was broad-based and led by its Cloud business, up 28.4% on the pcg as well as continued strength in YouTube advertising revenue, up 20.9%. Cloud and YouTube collectively are expected to exit 2024 at a run rate of US\$100b alone.</li> <li>Cost control was a major feature of the margin improvement with last year's redundancies and other cost cutting measures seeing margin improvement flow through as headcount declined 5.1% over the pcg. Another important factor was the demonstration of operating leverage in its cloud business which saw operating margins expand from 2.6% to 9.4% on the pcg.</li> <li>The company was at pains to call out its infrastructure for AI as best-class and well-placed to attract developers and new customers for multiple use cases. Cloud is seen as a major beneficiary of customer interest in AI with additional margin expansion to follow. Importantly, the business is also being endorsed by new startups with a majority of funded generative AI startups being Google Cloud customers and over 90% that have reached unicorn status (valued at over US\$1b being on Google Cloud). The company, as with peers, expects to continue reinvesting aggressively in the near term with capital spending at or above the March quarter's US\$12b due to surging customer demand with a focus on upgrading technical infrastructure particular servers and data centres.</li> <li>YouTube content continues to be a category leader for freeform video with daily viewing hitting over one billion hours of content. In addition, YouTube subscriptions gained traction with over 100m Music and Premium subscribers (including trials) globally as of 31 March.</li> <li>Management announced the company's first-even dividend at US\$0.20 per share as well as an additional new US\$70b share buyback program with the business sitting on a "cash pile" of over US\$108b as of 31 March.</li> </ul>
Our comments	<ul style="list-style-type: none"> <li>The Alphabet business continues to be performing strongly. The company has multiple avenues for growth and thanks to improvements in its advertising capability as well as customer interest in AI solutions, it is seeing meaningful traction in areas such as Cloud as well as its unique YouTube offering.</li> <li>The focus on cost discipline has been an important one for the business as it reduces potentially frivolous ventures that distract management without yielding meaningful results for shareholders. While the commencement of a dividend was welcome, the more important aspect for shareholders is the high conviction buyback program which should continue to support returns in the new term by adding buying pressure to the stock.</li> <li>One area of concern will be whether demand for AI solutions slows down and sees inadequate returns on investment from the current spending. That remains to be seen but the near-term trend has been favourable and we would expect this to persist. We continue to monitor the situation as a demand-slowdown would likely have adverse earnings implications.</li> </ul>





## Johnson & Johnson (JNJ: US)<sup>5</sup>

Share price	10/6/24: US\$147.13
Result	Q1 FY24
Revenue	\$US21.4b, up 2.3% on the pcp (up 7.6% on an underlying adjusted basis).
Underlying EPS	\$US2.71, up 12.4% on the pcp.
Key points	<ul style="list-style-type: none"> <li>• Business results were complicated by the divestiture of its Consumer Health business, now separately listed as Kenvue (US: KVUE).</li> <li>• MedTech continued to be a source of strength with 6.3% global sales growth on a currency-adjusted basis as deferred surgeries are now being progressively implemented, consistent with the Abbott experience.</li> <li>• We also saw a strong result in the Innovative Medicine segment after allowing for the decline in coronavirus vaccine sales with adjusted revenue growth of 8.3% on the pcp. This was driven by a mix of new treatments as well as taking market share in Oncology and Immunology categories.</li> <li>• A stronger US dollar remained a headwind to results detracting 1.4% and 1.8% from Innovative Medicine and MedTech sales growth respectively.</li> <li>• The business continues to be diligent in its approach to capital allocation with US\$3.5b invested in research pursuits during the March quarter and US\$2.9b in dividends to shareholders.</li> <li>• Management increased their full year guidance an additional 0.25% in underlying revenue growth and 0.2% uptick in underlying EPS. The quarterly dividend was increased to US\$1.24 per share, up 4.2% and marking the 62<sup>nd</sup> year of consecutive dividend increases.</li> <li>• Separately the business announced a US\$13.1b acquisition of heart device firm Shockwave Medical in a bid to build its leadership in cardiovascular technology.</li> <li>• Finally, the company's legacy liability for talc products continues with thousands of lawsuits underway and a number coming to trial this year. The company did benefit potentially from a ruling in March allowing it to contest scientific evidence linking its talc products to ovarian cancer where it believes it has a strong case for disproving the claim.</li> </ul>
Our comments	<ul style="list-style-type: none"> <li>• The business is executing reasonably well although coronavirus vaccine sales continue to be a near-term drag on its pharmaceuticals business. The aggressive expansion via acquisition in medical devices is supporting revenue growth though it will take time before it is clear whether these new franchises are earning an adequate return on investment.</li> <li>• The company remains well-placed as a growing, disciplined capital allocator at an undemanding valuation with a strong balance sheet and attractive dividend yield (3.4% for 2024 consensus).</li> <li>• However, two lingering concerns that continue to weigh on the share price in our view are: first, how much organic growth is the business able to generate versus a reliance on acquisitions. Second, is whether the talc liabilities will ever be demonstrably resolved. Until this occurs, we suspect the business may continue to trade at a meaningful discount to the peer group notwithstanding a strong recovery from pandemic-related backlogs.</li> </ul>



## Microsoft Corporation (MSFT: US)<sup>5</sup>

<b>Share price</b>	10/6/24: US\$427.87
<b>Result</b>	Q3 FY24
<b>Revenue</b>	\$US61.86b, up 17% on the pcp.
<b>Underlying EPS</b>	\$US2.94, an increase of 20% on the pcp.
<b>Key points</b>	<ul style="list-style-type: none"> <li>• Microsoft saw a strong start to 2024 with consensus beats on both revenue and earnings by 1.6% and 3.9% respectively.</li> <li>• Its Cloud business continued to be a highlight with 31% sales growth in Azure and management flagging a further 31% growth next quarter, ahead of consensus expectations. Whilst smaller than AWS, Microsoft's Cloud continues to take market share with growth consistently outpacing AWS in recent years. It is even achieving higher growth than the comparably smaller Google Cloud offering, a much harder feat given its larger size.</li> <li>• An investment "arms-race" continues to be a feature of major technology company spending with US\$14b in this quarter, a full US\$1b above consensus estimates. Management flagged that this remained in response to strong customer demand and the need to scale capacity in line with this.</li> <li>• The devices business continued to be a point of weakness with sales down 16% on the pcp but given its comparably smaller scale this was not a focus for investors.</li> <li>• The closing of the Activision acquisition saw gaming revenues surge 62% on the pcp. It will bear close watching to see how management look to turn around the underperforming Activision business and capitalise on its library of valuable content. Housed within the broader Microsoft business it should, ideally, be better placed to execute with long-term thinking and more focused management and be more successful as a result.</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>• Microsoft continues to be one of the major beneficiaries of AI interest amongst enterprises globally. Unlike peers such as Meta, the combination of AI investment coupled with stronger-than-expected sales growth has been warmly received by investors as a signal that the spending should earn attractive returns on the capital deployed.</li> <li>• AI-integration appears to be paying dividends with the OpenAI relationship supporting increased customer interest particularly in the company's Cloud offering.</li> <li>• The Activision acquisition will bear monitoring to see if it can support a more prolonged uptick in the gaming franchise. Activision has had a troubled history in recent years, and it may take time to reposition the assets accordingly in order to generate attractive returns on the capital deployed.</li> </ul>



## Nestle S.A. (NESN: CH)<sup>5</sup>

Share price	10/6/24: CHF 95.60
Result	Q1 FY24
Revenue	CHF 22.1b, down 5.9% on the pcg.
Key points	<ul style="list-style-type: none"><li>• Currency was a major headwind to start 2024 for Nestle, reducing sales growth by 6.7%. Business sales also reduced revenue growth by 0.6%.</li><li>• Notwithstanding this, the underlying business still had its share of challenges with organic sales only up 1.4% on the pcg. This was a mix of price increases (contributing 3.4%) offset by continued volume weakness (a drag of -2%).</li><li>• Weak consumer demand was a concern notably in North America where organic growth declined 2.5% driven by weaker sales of frozen foods as lower income households cut back on discretionary spending. Supply constraints were also a factor in the Health Science division where the rollout of new automation systems in its US packaging centres ran into issues. This contributed to a 1.8% decline in organic sales but is expected to be resolved by the end of the first half of 2024.</li><li>• Management did confirm their full year guidance for 2024 which anticipates an acceleration for the remainder of the year with organic sales growing 4% and underlying EPS to be up between 6% and 10% on a constant currency basis.</li><li>• They expected this recovery in organic sales growth to be driven by new product innovation and marketing spending. The easing of supply chain issues is also expected to be a major support as is the lapping of US government support payments that had inflated sales to lower-income households in 2023.</li></ul>
Our comments	<ul style="list-style-type: none"><li>• Nestle has been a disappointing performer in recent years after benefitting substantially at the height of the pandemic. Management has leaned on higher prices to preserve margins, but this strategy has come at the cost of losing volume to competitors as well as private label alternatives.</li><li>• Management has been aware of these issues however and we are watching closely to see if their efforts in product innovation will bear fruit particularly as consumer finances are challenged in a higher interest rate environment at present.</li><li>• The valuation is relatively undemanding for a stock we expect to see high single digit earnings growth from over the long term. The dividend yield is at its highest since 2018 and conversely the shares trade at ~18x 2025 estimated EPS, a level last seen in 2014. While the stock has lagged the broader market, we still find it attractive for its defensive growth profile and typically lower-than-market levels of risk. We are happy to maintain our exposure as a result.</li></ul>



## Novo Nordisk (NOV: DK)<sup>5</sup>

Share price	10/6/24: US\$143.63
Result	Q1 FY24
Revenue	DKK 65.349b, up 22% on the pcg.
Underlying EPS	DKK 5.68 per share, an increase of 29% on the pcg.
Key points	<ul style="list-style-type: none"><li>Novo Nordisk saw a strong start to 2024 with results that beat expectations on both sales and earnings by 2.5% and 8.6% respectively.</li><li>North American sales were a key growth driver with an increase of 36% on the pcg driven by its weight loss drug Wegovy which was approved for cardiovascular risk reduction in obesity patients. These results were flattered by rebate adjustments that could contribute an estimated 2-3% for both revenue and earnings growth for the full year according to Bloomberg Intelligence.</li><li>The company continues to be a leader in both weight loss drug sales as well as diabetes treatments. In both cases it saw increased gains in market share that underpinned the sales growth on the pcg. GLP-1 share rose to 55.3%, up from 54.5% globally, driven by its international operations. In diabetes care we also observed share gains with 34% in March 2024, up from 32.2% in the pcg.</li><li>Management upgraded guidance expectations with sales growth of 19%-27% in constant currency terms for 2024, up from 18%-26% in January. On a similar basis, operating profits are expected to grow 22%-30%, up from 21%-29%.</li><li>The guidance upgrade is expected to be predominantly driven by volume growth in GLP-1 products.</li><li>The company announced the acquisition of Cardior Pharmaceuticals for up to €1.025b, a firm pioneering heart disease treatments using RNA therapies. This represents a notable step towards the company's ambitions in building a cardiovascular disease offering.</li><li>The company continues to be diligent in the returning of excess capital to shareholders with approximately €4.2b in both dividends and buybacks during the March quarter (a shareholder yield of ~0.8% or 3.4% when annualised)</li></ul>
Our comments	<ul style="list-style-type: none"><li>Novo, together with US rival Eli Lilly continues to see substantial demand for GLP-1 products driving business results and dwarfing their other offerings. Pleasingly, they have maintained discipline in capital allocation ensuring shareholders are receiving a portion of these above-average earnings through dividends and buybacks.</li><li>Supply constraints for its GLP-1 productions remain a lingering concern in terms of meeting lofty investor expectations. The pace of growth however suggests these should be a near-term headwind rather than a permanent issue for the business as demand remains resilient.</li><li>Another factor that could impact the company is the rise of viable substitutes for GLP-1 drugs. A recent example in Australia<sup>9</sup> of compounded medications being ultimately outlawed highlights this issue. This is an area we are monitoring but given the health risks associated with these alternatives to date and the lack of substantive inroads we do not believe it is a pressing issue for the business at this juncture.</li><li>We believe the company remains well-placed to capitalise on strong demand for its GLP-1 solutions with a focus on continued reinvestment likely to underpin growth over the long term and offer an attractive growth profile for investors.</li></ul>

<sup>9</sup> 'Safety put first in compounding ban', *Diabetes Australia* (22 May 2024), <https://www.diabetesaustralia.com.au/news/safety-put-first-in-compounding-ban/#:~:text=Diabetes%20Australia%20welcomes%20the%20Federal,production%20from%20October%201%2C%202024> (accessed 10 June 2024).



## Nvidia (NVDA: US)<sup>5</sup>

<b>Share price</b>	10/6/24: US\$121.79
<b>Result</b>	Q1 FY25
<b>Revenue</b>	\$US26.04b, up 262% on the pcg.
<b>Underlying EPS</b>	\$US0.612, an increase of 427% on the pcg (this is on a split-adjusted basis).
<b>Key points</b>	<ul style="list-style-type: none"> <li>Nvidia continued to exceed expectations with sales and earnings both above consensus forecasts by 5.5% and 8.4% respectively.</li> <li>Management guided to US\$28b in sales for the three months ending in July, over 5% ahead of consensus estimates (US\$26.6b).</li> <li>Data centre sales continue to underpin business performance as an arms race amongst major tech companies for Nvidia chips continues to be waged. This segment saw sales growth of 427% with new collaboration efforts announced to advance generative AI with Microsoft, AWS, Google Cloud and Oracle during the quarter. CEO Jensen Huang also announced the company's next generation AI chip, Blackwell, was on track to launch by the fourth quarter of this year with substantial, further revenue growth expected to ensue.</li> <li>The sale of networking components has also grown substantially at over US\$3b, primarily from its InfiniBand products which are critical in linking the many thousands of chips being deployed by customers. As an illustration, Meta's latest large language model Lama 3 requires 24,000 H100 GPUs to operate, each costing ~US\$25,000 (reality is likely cheaper due to bulk discounts) making efficiency improvements extremely valuable.</li> <li>By contrast other business segments were more lacklustre with Gaming sales up 18% on the pcg and, Professional Visualisation and Automotive revenue up 45% and 11% respectively on the same basis. AI integration remained a key feature for both Gaming offerings and its Professional Visualisation solutions. Meanwhile leading Chinese electric vehicle producer BYD announced it would be leveraging Nvidia's Drive Thor platform to power their new commercial and consumer vehicle offerings.</li> <li>Management also guided to a 10-for-1 stock split which has now been implemented. This has no impact on business fundamentals but it does make it easier for retail investors to acquire shares.</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>Nvidia as a leading "picks and shovels" play continues to be attractively positioned to profit from strong end-customer demand for AI solutions.</li> <li>The business growth has been impressive and looks to be sustainable in the near-term as customers look to maintain their edge on rivals with limited supply matching Nvidia's edge.</li> <li>One concern is the weaker relative growth being experienced in other business segments meaning the company is increasingly reliant on data centre demand to drive growth. This is undoubtedly a good problem to be faced with given the scale of demand but it will likely pose an issue if growth begins to slow in the future and cast doubt on current expectations for strong growth.</li> <li>Those same growth expectations (EPS to increase over 47% p.a. over next 3 years) are critical to the valuation of the business and any signs of a slowdown in spending by the major technology names is likely to coincide with a share price correction.</li> <li>We are content to maintain exposure to Nvidia given its high margins and strong growth narrative with burgeoning demand for AI-powered solutions across its customer base and the company's ambitions to extend this into other verticals such as healthcare.</li> </ul>



## Universal Music Group (UMG: EU)<sup>5</sup>

Share price	10/6/24: €28.25
Result	Q1 FY24
Revenue	€2.59b, up 5.8% on the pcp.
Underlying EBITDA	€0.59b, an increase of 13.2% on the pcp.
Key points	<ul style="list-style-type: none"> <li>• UMG has a strong start to 2024 with both revenue and EBITDA (a profitability measure) ahead of consensus expectations by 0.5% and 3% respectively.</li> <li>• Currency volatility was a headwind with a stronger euro dragging on sales growth by 2.1% on the pcp.</li> <li>• Its Recorded Music division had a mixed set of results with revenue up only 3.4% on the pcp. Subscription and streaming revenue growth of 10.3% was notable but also offset by the secular decline in downloads revenue (falling 16.4%). Physical revenue weakness (down 18.5%) was another offsetting factor due to a very strong 2023 particularly in Japan.</li> <li>• Music Publishing was the standout performer with sales up 16.7%. This was driven by strength in digital revenue, up 22.9%, and the ongoing demand for live events with performance revenue rising 26.7% on the pcp. This was partly offset by weakness in other, smaller sub-segments of the division.</li> <li>• As a result of revenue growth and operating leverage, as well as the employee share scheme implemented last year, we saw underlying EBITDA profitability improved with margins rising 1.5% to 22.8%.</li> <li>• Finally, social video platform TikTok announced it had signed a new deal with UMG that will lead to increased royalties for the artists and songwriters it represents.</li> </ul>
Our comments	<ul style="list-style-type: none"> <li>• UMG in our view remains a standout record label with an enviable selection of artists, most notably Taylor Swift, and strong catalogue of recorded music to underpin revenue growth over the longer term. We should not underestimate the quality of its offering as artists such as Taylor could quite feasibly fund a similar support network given her popularity but the fact she partners with UMG highlights the attractiveness of its brand and people.</li> <li>• The TikTok deal is a welcome conclusion to a saga that threatened to potentially undermine its digital revenue growth story given the popularity of the platform.</li> <li>• Overall, we believe the business is well-placed to continue compounding earnings in the low teens over the medium term with a growing dividend yield further underpinning investor returns.</li> </ul>



## Visa Inc. (V: US)<sup>5</sup>

Share price	10/6/24: US\$275.04
Result	Q2 FY24
Revenue	\$US8.8b, up 10% on the pcg.
Underlying EPS	\$US2.51, an increase of 20% on the pcg.
Key points	<ul style="list-style-type: none"> <li>• Visa had a strong start to 2024 with the company exceeding consensus forecasts on both sales and earnings by 1.7% and 2.9% respectively.</li> <li>• Ongoing strength in payment volumes particularly cross-border (e.g. travel-related) remain the key driver of the strong performance with payments volumes up 8% on the pcg and cross-border volumes, double this rate, up 16%.</li> <li>• Foreign currency was a slight headwind, detracting 1% from earnings growth on the pcg.</li> <li>• The company completed its acquisition of Latin American tech company Pismo. This will allow the business to offer customers core banking and card issuer processing capabilities via cloud-native APIs. It is part of a broader platform offering by Visa to ensure it remains in place as a key payments platform and is not circumvented via digital transformation efforts.</li> <li>• Management maintained their outlook for FY24 with revenue and operating costs expected to grow in a low double-digit range. Operating leverage is expected to support EPS growth in the low teens on an underlying basis.</li> <li>• They also announced a class action settlement with a number of smaller businesses which would lower Visa charges and offer more flexibility in choice of digital payments. This does pose a risk to the business potentially to the extent that lower pricing does not make up or offset volume growth. It also reinforces the need for efforts such as Pismo to broaden the attractiveness of Visa's offering to merchants by building other links e.g. better software integration. Value-added services to that end remain an important feature of the business and also helped drive the beat against consensus revenue expectations.</li> <li>• Another potential avenue for growth flagged by management lies in government payments. This is being targeted as an attractive vertical globally given annual volumes of over US\$15 trillion per annum.</li> </ul>
Our comments	<ul style="list-style-type: none"> <li>• Visa continues to be a strong compounder offering low double-digit earnings growth at attractive margins with a pleasing focus on capital returns via both dividends and buybacks. The company also trades at a reasonable valuation relative to its quality and growth potential setting the stage for above-market growth over the medium term.</li> <li>• Efforts to circumvent the Visa network bear close observation with management being proactive in our view. Adding more value via services and new product offerings should help entrench the attractiveness of Visa and reduce erosion of the company's moat by new entrants. One fear is that major tech companies would enter this space given the size of the market opportunity. It would not be an easy feat however given the scale of merchant links and the infrastructure already in place. It is one threat though that we continue to monitor closely.</li> </ul>

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This view is general advice only and does not take into account your personal circumstances or finances. If you have further questions, we encourage you to consult with your adviser.





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