PENDAL

Pendal Monthly Commentary

Pendal Australian Shares Portfolio

February 2024

Market commentary

Australian equities bounced around in February before ultimately rallying into the month's end and posting a 0.98% gain for the month (S&P/ASX 300).

The broad underlying picture of disinflation opening the way to rate cuts in 2024 remains in place.

However some stronger than expected economic and inflation data in the US have tempered previous expectations around the timing and scale of rate cuts.

In Australia the RBA kept rates on hold. Governor Bullock noted that inflation remains too high, but that recent developments are encouraging. She also noted that the CPI will not necessarily need to be back within the 2-3% target range before the first cut.

The outlook from Australian earnings season was slightly better than average, with 28% of stocks seeing EPS upgrades for FY24 - versus a long-term average of 22%. 33% saw downgrades, just under the long-term average for 34%.

The consensus FY24 earnings-per-share outlook for the ASX 200 remains unchanged following reporting season, with slight upgrades for banks and industrials offsetting slight downgrades for resources.

Information technology (+19.70%) was the stand-out sector, helped by good results from NextDC (NXT, +25.89%) and Wisetech (WTC, +29.44%), a takeover bid for Altium (ALU, +30.41%) and a well-received investor day from Xero (XRO, +14.91%).

Consumer Discretionary (+9.74%) also outperformed as the revenue environment for retailers remains better than expected, while they are also generally maintaining good control of costs. Wesfarmers (WES, +16.22%) beat expectations on the back of Kmart, while JB Hi-Fi (JBH, +10.37%) benefited from stronger than expected margins at The Good Guys.

Energy (-5.94%) underperformed. Woodside Energy (WDS, -6.33%) and Santos (STO, -6.38%) announced that they would not pursue potentially merger talks any further, introducing an element of uncertainty into the outlook for both companies.

Materials (-4.80%) also lagged as continued caution over the outlook for the Chinese economy weighed on the price of iron ore (-11.7%). This weighed on BHP (CHP, -7.07%), Rio Tinto (RIO, -6.88%) and Fortescue (FMG, -9.61%) despite all three delivering reasonable results.

Portfolio overview

Australian Shares Portfolio	
Investment strategy	Pendal employs a bottom up, fundamental approach to build a diversified portfolio of Australian shares where the majority of active risk and outperformance is driven by stock selection. The portfolio will focus primarily on capital growth.
Investment objective	To deliver outperformance relative to the benchmark after fees over a rolling three year period.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15 - 35 (31 as at 29 February 2024)
Sector limits	Australian Shares 60 - 98% Australian Property 0 - 30% Cash 2 - 10%
Dividend Yield	3.42%#
Income target	No target

Top 10 holdings

Code	Name	Weight
BHP	BHP Group Ltd	11.72%
CSL	CSL Limited	8.94%
CBA	Commonwealth Bank of Australia	6.47%
NAB	National Australia Bank Limited	6.28%
TLS	Telstra Group Limited	5.25%
WBC	Westpac Banking Corporation	5.14%
STO	Santos Limited	5.12%
XRO	Xero Limited	4.59%
GMG	Goodman Group	4.07%
QAN	Qantas Airways Limited	3.84%

Source: Pendal as at 29 February 2024

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
STO	Santos Limited	4.14%
XRO	Xero Limited	3.83%
QAN	Qantas Airways Limited	3.47%
TLS	Telstra Group Limited	3.38%
CSL	CSL Limited	3.07%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
ANZ	ANZ Group Holdings Limited (not held)	-3.63%
WES	Wesfarmers Limited (not held)	-3.21%
WDS	Woodside Energy Group Ltd (not held)	-2.45%
FMG	Fortescue Ltd (not held)	-1.86%
CBA	Commonwealth Bank of Australia	-1.81%

Source: Pendal as at 29 February 2024

#The Portfolio's dividend yield represents the weighted average 12-month forward-looking dividend yield of the portfolio holdings (excluding cash), as at the date of the Factsheet. Each individual security's dividend yield is calculated using market consensus Dividend Per Share (DPS) before tax and franking credits, collated by Pendal and divided by the closing market price of the security as at the date of the Factsheet. The portfolio dividend yield therefore is only an estimate, and does not reflect the actual returns of the Fund, which will be affected by market movements in the price of individual securities, the returns on other assets such as cash holdings and variances of individual security's actual dividends from the forecasted DPS.

Performance

	1 month	3 month	6 month	1 year	3 year (p.a.)	5 year (p.a.)	Since inception (p.a.)*
Pendal Australian Shares Portfolio	0.61%	9.07%	6.06%	10.09%	8.79%	9.45%	9.35%
S&P/ASX 300 (TR) Index	0.98%	9.46%	7.44%	10.50%	9.08%	8.60%	8.17%
Active return	**-0.37%**	**-0.40%**	**-1.37%**	**-0.41%**	**-0.29%**	**0.85%**	**1.18%**

Source: Pendal as at 29 February 2024

*Since Inception - 15 June 2015

Performance returns are pre-fee. Investors should contact their platform provider for applicable fee rates.

Past performance is not a reliable indicator of future performance.

Top 5 contributors - monthly

Code	Name	Value Added
XRO	Xero Limited	0.47%
NXT	Nextdc Limited	0.33%
GMG	Goodman Group	0.26%
FMG	*Fortescue Ltd (not held)*	*0.23%*
WDS	*Woodside Energy Group Ltd (not held)*	*0.19%*

Top 5 detractors - monthly

Code	Name	Value Added
WES	*Wesfarmers Limited (not held)*	*-0.43%*
STO	Santos Limited	-0.35%
QAN	Qantas Airways Limited	-0.33%
CSL	CSL Limited	-0.20%
BHP	BHP Group Ltd	-0.20%

Top 5 contributors - 1 year

Code	Name	Value Added
XRO	Xero Limited	1.54%
JHX	James Hardie Industries PLC	0.82%
NXT	Nextdc Limited	0.65%
WDS	*Woodside Energy Group Ltd (not held)*	*0.50%*
GMG	Goodman Group	0.46%

Top 5 detractors - 1 year

Code	Name	Value Added
QAN	Qantas Airways Limited	-1.40%
LTM	Arcadium Lithium Plc	-0.85%
WES	*Wesfarmers Limited (not held)*	*-0.81%*
S32	South32 Ltd.	-0.64%
TLS	Telstra Group Limited	-0.47%

Source: Pendal as at 29 February 2024

Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Xero (XRO, +14.91%)

XRO's inaugural investor day was well received. Management outlined a new strategy focused on three "super-core" products (accounting, payroll, payments) in their three largest markets (Australia, UK, USA). They also introduced the new executive management team, outlined an aspiration to double revenue and maintain the "Rule of 40" whilst also reiterating FY24 guidance. The market's reaction suggests greater confidence in XRO's ability to deliver on the 40% revenue growth plus profit margin target.

Overweight NextDC (NXT, +25.89%)

Data centre operator NXT delivered a result that included less of a step-up in costs and capex than had been feared, resulting in earnings that beat expectations. There was no change to full year revenue and earnings guidance, which still looks on the conservative side, in our view. NXT's strong development pipeline drew attention, with strong demand from enterprise, hyperscale cloud and Generative AI. We remain positive on the long-term outlook for NXT with a strong competitive position and inventory available at an important point in the cycle.

Overweight Goodman Group (GMG, +16.80%)

GMG beat consensus 1H FY24 earnings by 13%, driven by recognition of embedded profits across their land banks. The company is increasingly focussed on GMG's data centre developments, where the total pipeline of projects was increased and the timing of delivery brought forward. Data centres now accounts for 37% of GMG's work in progress. Meanwhile, operating metrics for industrial remains robust. Softer cap rates and negative revaluations are resetting operating businesses for future growth.

Three largest detractors

Underweight Wesfarmers (WES, +16.22%)

WES grew group EBIT by 1.4% and EPS 3% for 1H FY24, beating expectations mainly due to strength in Kmart. It will be difficult for Kmart to sustain recent margin strength in our view. Other retail businesses such as Bunnings and OfficeWorks were well managed in a period of high wage inflation and sub-2% revenue growth.

Overweight Santos (STO, -6.38%)

Santos's result was in-line with expectations operationally, although some one-off, non-cash items saw it miss consensus profits expectations. However the focus remains on management's plan to close the discount to the value of its assets and realise shareholder value. In this vein, the news that merger talks with Woodside were shelved in early February weighed on the stock. Management have indicated that they continue to look at other opportunities.

Overweight Qantas (QAN, -7.73%)

QAN delivered profit before tax (PBT) of $1,245 for 1H FY24, a touch under consensus expectations at $1,259. The result demonstrated that demand and market share are not deteriorating and fundamental conditions remain supportive of structurally higher levels of profitability post-Covid. Management flagged seasonal headwinds for 2H FY24, which drove ~8% downgrades. However we believe this does not fully account for some offsetting factors such as fuel and capacity growth. FY25 should see a marked improvement in margins versus FY24 in our view.

Outlook

The economic backdrop remains reasonably benign for markets, although we remain mindful of still material risks.

US inflation continues to trend in the right direction, which opens the door to rate cuts at some stage. February did see some inflation data points that were higher than expected. The message from the Fed is that the path to lower inflation is unlikely to be linear and that the overall trend remains in the right direction.

At the same time, the US economy is holding up relatively well. This is important as it means the Fed can afford to sit on its hands and wait for confirmation that inflation is indeed being brought under control.

If we start to see a material deceleration in the economy, it would risk an earnings recession which could drag on markets. It could force the Fed into cutting rates sooner than they otherwise would.

At the other end of the spectrum, there is also the risk that inflation remains stubborn high or even rebounds. This could also drag on markets, which continue to price in cuts for 2024, even if the number of expected cuts has been reduced in recent weeks.

For the moment, though, inflation is on the right path and the economy is holding up well.

Likewise in Australia, earnings season is telling us the economy is OK. There is the odd pocket of softness but generally trends are continuing as before.

Industrial and tech companies are doing better, while large consumer-facing companies are wary of delivering a message which is too positive, for fear of a media backlash.

Aggregate ASX 200 earnings are expected to fall -4.2% in total for FY24, with some strength in industrials offsetting weakness in resources and banks. However at this point the market seems content to look through near-term weakness, which has seen a market valuation re-rating drive recent equity gains.

This re-rating has come in anticipation of the economy avoiding recession and the eventuation of rate cuts. We note that conditions remain benign and that there is still plenty of cash to be deployed in markets. This suggests that markets can continue to grind higher. However we are mindful that some of the valuation buffer has been removed if we do start to see a downturn in fundamentals.

Looking forward to FY25, consensus currently expects 2.8% EPS growth, with continued strength in Industrials and an improved – albeit still negative – outcome for the banks and resources.

New stocks added and/or stocks sold to zero during the month

Buy a new position in Scentre Group (SCG).

We are adding to the portfolio's position in rate-sensitives via the addition of Scentre Group (SCG). SCG owns and operates 42 Westfield shopping centres across Australia and New Zealand, a portfolio that delivered $28.4bn in retail sales in 2023.

Last year SCG faced twin headwinds from rising interest rates, which drove up interest costs as well as raised concern around a slowdown in consumer activity which saw the stock underperform. It is currently trading on 13.8x next-12-month price to earnings, which is attractive value compared to the broader AREIT sector.

We have now reached a point where rates appear to be at or near a peak, while the combination of population growth, a draw-down on savings, and additional hours worked have led to consumer resilience.

At the same time, SCG management have navigated the environment well, as demonstrated in its 2023 result where it generated 5.2% earnings growth.

This was driven by top line rental growth (as specialty store leases have annual inflation-linked increases), improved occupancy levels (occupancy rose +30bp to 99.2%) and positive leasing spreads (signing leases on expiring specialty leases +3.1% over expiring rents).

The group's strategy of reducing holdovers (occupied space but not secured with a lease) combined with the lack of new retail space has meant that there are limited amounts of space for tenants looking for better space/planning expansion. The resulting competitive tension has led to strong occupancy and rental growth.

Tenant sales continue to improve with specialty sales accelerating in 4Q23 +3.1%. In the medium term the group will be repurposing department store space (mostly David Jones) at significantly higher rents and better sales productivity.

Debt is elevated at 40% total debt to total assets. This remains something to watch, however management are confident that it can refinanced and/or repaid with asset sales.

The fundamental outlook looks good, while the headwinds of the macro environment also appear to be receding. As a result we are taking advantage of attractive valuation to add a high quality property exposure to the portfolio.

For more information contact your
key account manager or visit **pendalgroup.com**

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