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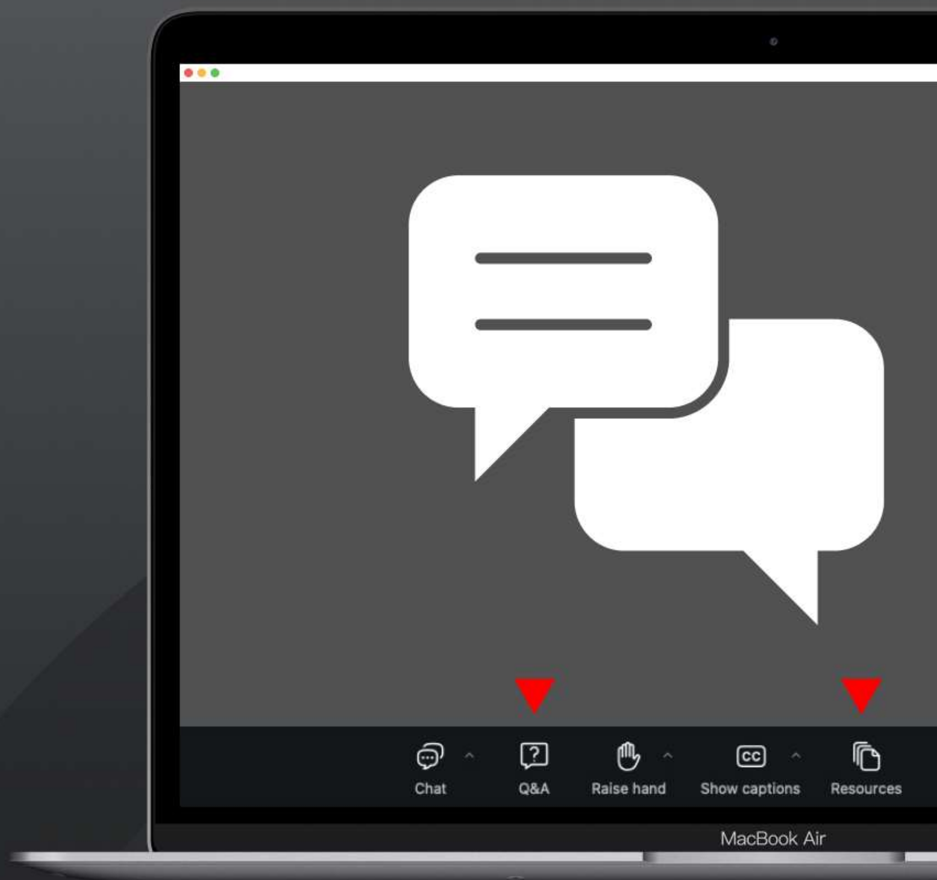

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Morningstar retirement bootcamp

Tuesday 22 October | The case for and against income investing

Income investing remains controversial with some professional investors. We will walk through the arguments for and against income investing and if investors should consider pursuing this strategy.

Tuesday 29 October | Building an income portfolio

Investors love dividends but creating an income stream involves more than just picking the highest yielding shares. We will walk through the process to put together a portfolio.

Tuesday 12 November | Assessing individual income shares

A step-by-step process for assessing individual shares that can maintain and grow dividends.

Tuesday 19 November | Using ETFs to generate income

The structure of many dividend ETFs leads to lacklustre or non-existent dividend growth. Learn how to use ETFs as part of an income portfolio

Learning objectives

1. How do you evaluate the dividend potential for a share and how to consider what is right for your own portfolio.

What is an income portfolio?

Investing for income or for total return is often portrayed as a trade-off for investors. There may be a trade-off in maximising immediate income and longer-term total returns but for most investors a longer-term income strategy also involves finding great companies.

There are three steps needed to evaluate a dividend share:

1. Management's willingness to pay a dividend
2. Cash flows to support a dividend
3. Financial flexibility to pay a dividend

Willingness to pay a dividend

A dividend is a choice and even if a company is in the financial position to pay a dividend they may not. There are two things an investor can do to assess management's willingness to pay a dividend:

1. Look at the history of dividend payments which can provide a window into management's approach
2. Go to the investor's relation section of a company's website to see if they have an established dividend policy which generally is expressed in a range of earnings that are being targeted.

Dividend policy

What is CBA's dividend policy?

Commonwealth Bank of Australia will seek to:

- pay cash dividends at strong and sustainable levels;
- target a full-year payout ratio of 70% - 80%; and
- maximise the use of its franking account by paying fully franked dividends

Cash flows to support a dividend

Evaluating the prospects for a dividend differs little from evaluating the prospects for a share. An investor should start with gaining a high-level understanding of the company and the competitive environment within which it operates. Specifically, an investor should have an understanding of the following:

What will influence top-line / revenue growth:

- Is the overall market for the goods and services sold by the company growing or shrinking? *(explore total addressable market for the industry and growth trends)*
- Will there be changes in market share between existing or new competitors? *(look at market share, changes in market share and try and determine what drives purchasing decisions of consumers)*
- How will pricing for goods and services change in the future? *(how sensitive are consumers to price changes, what are substitutes, are there switching costs, etc.)*

Cash flows to support a dividend (continued)

How much revenue will flow to the bottom line?

- What factors influence the cost to deliver and sell goods and services? *(Is the business model inherently scalable? Does the cost per unit come down with increased scale? How has the operating margin changed over time and why?)*
- What other costs are associated with the business? *(Is there scalability with fixed costs or will they increase as the company grows? How has the net interest margin changed over time and why?)*
- Are non-cash expenses like depreciation and amortisation representative of real costs? This is particularly critical for a company with lots of assets on the balance sheet where cash flows may be higher than earnings. *(when will depreciating assets need to be replaced or can they be maintained indefinitely, what future investments are needed to support the business, what is the impact of intangible assets on the company?)*

Cash flows to support a dividend (continued)

Can the company take advantage of opportunities for growth?

- Can the company continue to innovate and grow over the long-term? *(Has the company had a history or profitably investing in the business through high returns on capital and equity?)*
- What are the business risks to long-term growth?

Is the company in financial position to support dividends?

A company that is in financial stress can loss the financial flexibility to pay dividends under certain conditions. In these cases, an established dividend policy may have to be altered, or historic payout rates may not be sustainable.

Investors typically look at ratios like debt to equity or debt to assets to measure the financial condition of a company. However, context matters. Investors should consider the following when looking at the overall debt levels of a company:

- How predictable are the cash flows a company generates? A company in a mature market with predictable earnings – perhaps even contractually established – can support higher levels or debt than a company with higher business risk and unpredictable cash flows.
- In periods of market disruption it can be challenging for a company to rollover debt. A company with a higher credit rating will have an easier time than a company with a lower credit rating. A company with debt maturities spread over multiple years is less risky than maturities bunched in a certain year.

Case study: CSL vs. Santos

CSL

Current yield: 1.39%

Dividend policy: CSL doesn't have a set dividend policy but has recently paid out ~40% of earnings.

Santos

Current yield: 6.76%

Dividend policy: A policy of at least 40 per cent payout of free cash flow from operations (flows less investing cash flows net of acquisitions and disposals and major growth capital expenditure.)

Shareholder returns to be effected by way of cash dividends and/or share buybacks, subject to market conditions and Board discretion.

Company	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Current
CSL	$1.14	$1.29	$1.25	$1.34	$1.73	$1.87	$1.99	$2.21	$2.26	$2.41	$3.97
STO	$0.28	$0.21	$0.04	$0	$0.04	$0.12	$0.07	$0.11	$0.16	$0.24	$0.46

Case study: CSL vs Santos

Metric	CSL	STO
3-year revenue growth	12.69%	20.25%
Gross margin (5 year)	54.15%	63.26%
Net margin (5 year)	20.97%	14.89%
3-year net income growth	3.62%	-
Debt to equity	.70	.42
Interest coverage ratio	9.04	7.81
Return on invested capital (5 year)	14.63%	5.76%
Morningstar Moat rating	Narrow	None
Morningstar Capital Allocation Rating	Exemplary	Standard
Morningstar Uncertainty Rating	Medium	High

Case study: CSL vs. Santos

CSL industry – highly concentrated industry and industry leader in multiple areas.

The plasma therapies market is a three-player oligopoly held by CSL, Grifols, and Takeda Pharmaceuticals. Together, the Tier 1 companies have an estimated 80% market share and a cost advantage over smaller competitors. Gross margins of the Tier 1 trio are on average 20 percentage points higher than tier two players such as Octopharma.

CSL is the second largest influenza vaccine manufacturer, behind Sanofi, and is on the forefront of changes in influenza vaccines where manufacturing is shifting from egg-based to cell-based culturing. It's also conducting preclinical testing of mRNA influenza vaccines

Santos industry – small overall player and prospect reliant on continued demand and pricing of gas.

The primary source of competitive advantage for resource stocks stems from maintaining lower costs than peers. We don't think Santos qualifies on this front.

Liquefied natural gas is an upfront capital-intensive business, and Australia's remoteness and underdeveloped industrial base makes for particularly high capital costs in contrast to markets with deeper services industries like the US.

Hydrocarbons' share of primary energy consumption fell to 84% from 87% over the last decade, though in absolute terms consumption increased by 15%. Share was displaced by renewables. We expect the trend for gas in particular to continue at least in the medium term, as the most effective way to quickly reduce emissions meaningfully. Gas' share of primary energy consumption increased to 24% from 22% over the last 10 years.

Case study: CSL vs. Santos

CSL topline – sold growth projected in major product lines.

We forecast five-year revenue growth CAGR of 8.0%.

- Our forecast includes five-year immunoglobulin market growth of 8% and CSL's share of the market increasing to 36% from 34% over this period.
- We anticipate the Seqirus vaccine business to grow at a 4% revenue CAGR over the next five years. The pandemic has buoyed the uptake of influenza vaccination and we expect this to largely continue.
- Haemophilia A is currently the most competitive market in which CSL operates and we forecast very limited growth based.

Santos topline – we expect pull back in prices but increased production coming online.

We assume a pullback in Brent crude price to a midcycle USD 60 per barrel by 2026 versus current levels nearer USD 80. This, regardless, supports a healthy 12% 10-year EPS CAGR to USD 1.35, or AUD 2.08, by 2033. We still forecast 10-year EBITDA CAGR of 5.7% to USD 6.6 billion and a midcycle EBITDA margin of 80% excluding third-party sales.

We expect production to increase 40% by 2026 as new projects come online.

Case study: CSL vs. Santos

CSL bottom line – increased margin to drive higher earns than revenue growth.

We forecast margin expansion leading to adjusted five-year EPS CAGR of 12.5%. .

- We forecast an improvement in CSL's operating margin to 32% by fiscal 2029 from 28% in fiscal 2024, a function of gross margin improvement stemming from product mix in CSL Behring and manufacturing gains in Seqirus.
- Much of this is driven by economies of scale that minimize the cost per liter to collect and process plasma. Processes such as purifying and testing are more efficient with higher volumes, as labor and overhead costs are leveraged. Vertical integration across the top 3 also reduces the need to purchase plasma on the open Tier 1 market.
- R&D spending averages approximately 10% of revenue per year and we expect it to continue at a similar rate.

Santos bottom line – an interplay between high capital expenditures to maintain and expand production and cash operating costs.

Liquefied natural gas is an upfront capital-intensive business, and Australia's remoteness and underdeveloped industrial base makes for particularly high capital costs in contrast to markets with deeper services industries like the US. Santos has favorably low cash operating costs, but these are largely countered by high capital costs, meaning it is not a low-cost operator on an all-in basis.

Case study: CSL vs. Santos

CSL investment returns – returns have historically exceeded cost of capital given the narrow moat.

Due to its significant market share and high gross margins, CSL has posted a return on invested capital, or ROIC, above 19% in each of the last eight years. We anticipate the company's ROIC to far exceed its weighted cost of capital of 7.4% over our 10-year explicit forecast period, even in our bear-case scenario

Santos investment returns – no moat so returns have generally met the cost of capital with cyclical spending.

We don't expect Santos to generate midcycle returns on invested capital materially above its cost of capital. Santos' return on invested capital has occasionally exceeded the weighted average cost of capital during periods of favorable commodity prices.

Case study: CSL vs. Santos

CSL long term business risks – Medium risk around continued success of R&D.

We think it's unlikely in our base case, that there's significant potential for biotech advancements to have an impact on the plasma industry; the variability in possible outcomes from CSL's own research and development pipeline is fairly wide.

CSL's ability to commercialize its R&D pipeline is also a risk. CSL has a track record of successful product launches but is attempting to expand into gene therapy and newer recombinants where its expertise is untested at this stage.

Santos long-term business risks – High based on industry dynamics.

Earnings are dependent on commodity prices which are outside of the control of the company and we believe this warrants a high risk.

Material ESG exposures create additional risk for investors. Significant exposures are greenhouse gas emissions (both from extraction operations and downstream consumption), and other emissions, effluents, and waste (primarily oil spills). Climate concerns could trigger regulatory interventions, such as fracking bans, drilling permit suspensions, and perhaps even direct taxes on carbon emissions.

However, natural gas is less carbon-intensive than coal or oil, and stands to benefit from efforts to minimize emissions. This is because renewables like wind and solar, while growing rapidly, can't hope to entirely meet global energy requirements for decades, if ever.

Case study: CSL vs. Santos

CSL financial condition – sound balance sheet and low cyclicality of business.

CSL's balance sheet is in sound condition. Financial risk is low given low revenue cyclicality and product demand is being largely driven by chronic indications. We forecast CSL's net debt to EBITDA to remain under 1 over the forecast period.

Santos financial condition – sound balance sheet but high cyclicality of business.

Gearing is healthy at a little changed 20% excluding leases, and that despite USD 1.5 billion exploration and development expenditure. It remains within Santos' targeted 15%-25% range, and approximately 1.1 net debt/EBITDA is sound and likely to remain so. There are no drawn debt maturities until September 2027.

We expect gearing to remain at conservative levels despite capital expenditure on expansion projects and ongoing buybacks. Santos' debt covenants have adequate headroom and are not under threat at current oil prices. The weighted average term to maturity is around 5.5 years.

Case study: CSL vs. Santos

Projected dividends

Company	2025	2026	2027	2028	2029	2030	2031	2032
CSL	$2.95	$3.37	$3.86	$4.37	$4.74	$5.07	$5.42	$5.79
STO	$0.20	$0.14	$0.23	$0.30	$0.32	$0.35	$0.37	$0.40

Does this make sense?

CSL is a non-cyclical company with a moat that is expected to have steady growth and high returns on invested capital with safe levels of debt. It is not surprising that historically and in forward projections the dividend is showing steady dividend growth.

STO is a cyclical company with high levels of periodic capital expenditures and reliant on volatile commodity prices but with safe levels of debt. It is not surprising that historically and in forward projections there is more variability in dividends.

However, STO has a significantly higher yield which is indicative of a lower valuation. The lesson is that dividends are reflective of the type of business you invest in and each investor needs to make their own trade-offs.