BUY HEALIUS (HLS), SELL COLES (COL)

May 2021

With the ASX having recovered virtually all of its COVID-19 losses we believe now is more important than ever to ensure stock selection within portfolios is robust enough to withstand any possible spikes in volatility.

As we continue to witness a rotation away from growth and the likelihood of rising inflation on the back of an unprecedented level of fiscal stimulus and record low interest rates, we believe industry leaders with strong cash flows, well capitalised balance sheets and low debt are best placed to outperform in the medium term.

We continue to focus on quality at a reasonable price with a sustained tilt towards value and our overarching view is that the value trade in a reflationary environment has further to run.

With this in mind we recommend **PURCHASING HEALIUS (HLS).**

HLS (formerly Primary Healthcare) is the second largest provider of private medical laboratory and pathology services in Australia comprising of three segments, Pathology, Imaging and Day Hospitals.

HLS currently has a 34% market share of medical laboratory services in Australia with pathology being its largest division having over 2,216 collection centres and 102 pathology labs. Its imaging division operates over 140 sites whilst its Day Hospitals and IVF division is now operating as its own segment following the divestment of its Medical Centres business in November last year.

Pathology is a medical specialty that focuses on determining the cause and nature of diseases and 70% of all medical decisions and 100% of cancer diagnoses rely on a pathology testing.

HLS's mission in pathology is to deliver accurate and timely diagnostic services Australia-wide with its most recognised brands being Dorevitch Pathology in Victoria, Laverty Pathology in NSW and ACT and QML Pathology in QLD and northern NSW.

Despite limited new cases in Australia, COVID testing volumes have remained at elevated levels and we believe Polymerase Chain Reaction testing (PCR) will continue to support near term earnings. PCR testing is further supported by the government's extension of $100 per test until FY22 and it remains to be the dominant mechanism to provide visibility on transmission.

Trading conditions remain supportive with Q3 non-Covid pathology revenue growth of +5% representing a continuation of a robust recovery dynamic. Imaging is displaying steady growth (~8% in Q3) and Day Hospitals continuing to deliver strong growth, underpinned by growing demand in short stay hospitals (increasing trend from overnight stays to day surgery encouraged by insurance companies).

HLS's balance sheet is now in pristine condition following the sale of Medical Centres with a bank gearing ratio of 0.7x well below the covenant ceiling of 3.5x. **HLS** trades on a forward yield of 3.5% fully franked and its current payout ratio of 55% is at the lower end of its 50%-70% target.

Finally, with **HLS** purchasing shares through an on-market buy-back (currently ~25% completed) there is further scope for upside in the share price.

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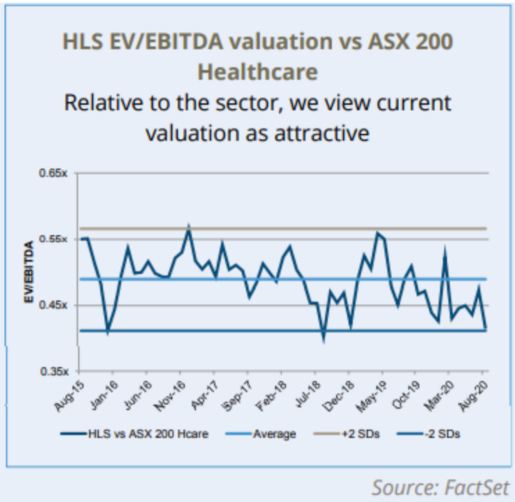
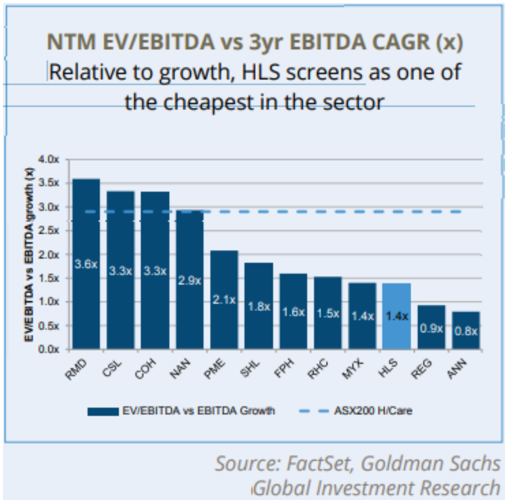
Healius remains one of the cheapest in the healthcare sector and is growing earnings per share (EPS) at 8% per annum.





With a de-risked balance sheet and the backdrop of unmet need and diagnosis recovery offering a medium term and dependable catalyst to earnings growth **we recommend PURCHASING HLS at current levels.**

In order to fund this, **we recommend SELLING COLES (COL).**

We have been closely monitoring **COL** since its disappointing 1H21 result, with the share price having now recovered around $1.50.

COL is no longer competing with **Woolworths (WOW)** the way it once was, having made significant inroads into closing the gap in food and liquor sales in FY16 and FY17.

Over the last 3 years **WOW** has increased food and liquor sales by an average pf 5% per annum compared to **COL**'s 1% with **COL** now clearly lagging **WOW** in the consumer staples sector across key metrics such as like-for-like sales. More recently **COL** has seen its online sales conversion grow +49% in Q3 compared to **WOW**'s +90%.

In order to compete with its biggest rival **COL** is being forced to increase capital expenditure with 1H21 results showing capex guidance was upgraded +10% for store refurbishments and to further compete in the online grocery market.

With incumbents such as Aldi heavily discounting products in efforts to gain market share, **COL** has had to drastically reduce prices across more than 250 stock products to remain competitive.

At 21x FY22 earnings **COL** trades on a higher multiple than the ASX200 and given our preference for 'industry leaders' we maintain a strong preference towards **WOW**.

In order to ensure your invested capital is working harder for you and providing a greater return profile **we recommend deploying the proceeds from COL into HLS.**