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Australian Strategy Insight

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Investment Strategy

Reporting season: Trends sluggish, tone mixed

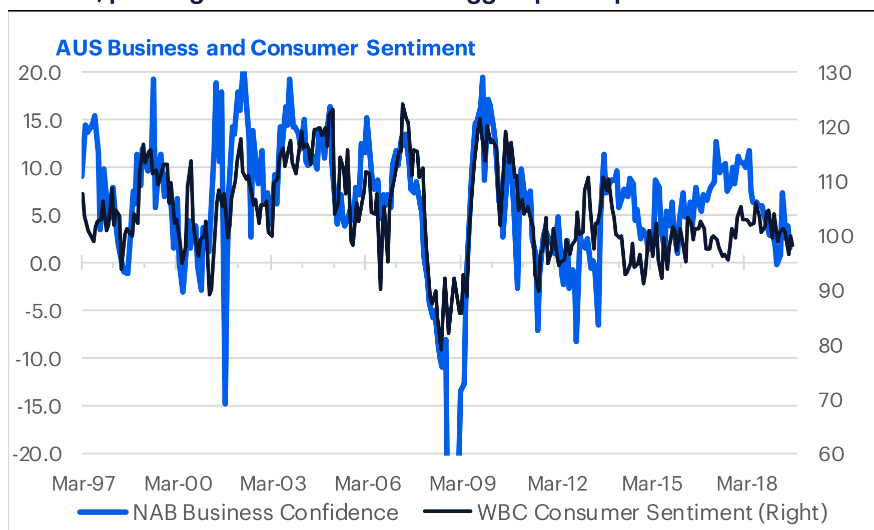
The ASX 200 – up ~18% year-to-date to near record highs, and in the process re-rating to a ~12% above average 16.3x forward PE – appears to have looked through a flat reporting season. Themes of the reporting season included anaemic top-line growth, elusive pricing power, a return to cost-cutting, and mixed, but generally cautious, outlook statements. Our indicators of activity in early 3Q19 point to a continuation of subdued growth – a negative for the earnings outlook – though a few companies have reported an improvement in operating conditions early in the new fiscal year.

Themes from the FY19 reporting season included:

i. **Anaemic top-line growth**: Top 20 revenue growth was a sluggish 2.7% YoY, consistent with 2Q19 real GDP growth of 1.4% YoY, which was around 28-year lows.
ii. **Some margin pressure**: Despite low cost pressure, elusive pricing power and sluggish growth drove modest margin pressure, pushing top 20 operating profit down 0.5% YoY. Sources of margin pressure included pressure on bank net interest margins and fees, soft same-store retail sales growth, telco margin pressure from the NBN, weak private healthcare trends and falling non-bulk commodity prices.
iii. **A return of cost-cutting:** The banks are resuming cost-cutting with cost ratio targets below 40%. A range of companies initiated cost-out programs.
iv. **Mixed, but generally cautious, FY20 earnings guidance:** Guidance outside health product companies was generally cautious. That said, some companies noted an improvement in trading conditions early in the new fiscal year, helped by rate and tax cuts.

Investment implications: We expect sluggish economic growth to drive another year of flat profits in FY20, well below consensus estimates for about 11% YoY growth. If so, forecasts of solid profit rebounds for the banks, industrials and consumer discretionary sectors seem aggressive.

Fig.1: AUS business and consumer sentiment has softened despite rate and tax cuts, pointing to a continuation of sluggish profits performance



Source: Datastream, EL&C Baillieu

Reporting season: Trends sluggish, tone mixed

- The ASX 200 equity market – up ~18% year-to-date to near record highs, and in the process re-rating to a ~12% above average 16.3x forward PE – appears to have looked through a flat reporting season. Themes of the reporting season included anaemic top-line growth, elusive pricing power, a return to cost-cutting, and mixed, but generally cautious, outlook statements. Indeed, our indicators of activity in early 3Q19 point to a continuation of subdued growth – a negative for the earnings outlook – though a few companies reported an improvement in operating conditions early in the new fiscal year. We recognise that the stimulus is still working its way through the economy but, unless it achieves unusual traction, we think another year of flat profits is in store for the Australian market; well below consensus estimates of ~11% YoY growth.

Reporting season has tempered earnings expectations

- The sluggish FY19 reporting season drove the ASX 200's consensus 12-month forward earnings estimate lower by 2.1% MoM in August, and by 1.0% over the past three months. Nonetheless, strong bulk commodity prices – at least until August – and a lower AUD have driven positive earnings momentum of +2.6% and 2.9% over the past 6- and 12-months respectively.
- Our analyst bottom-up earnings expectations have also moderated. A month ago, pre-reporting season, our analysts were expecting 2.5% YoY and 10.1% YoY growth in FY19 and FY20 respectively. These estimates have now moderated to 0.0% YoY in FY19 and 10.9% in FY20, pointing to an overall moderation of 1.7ppts.

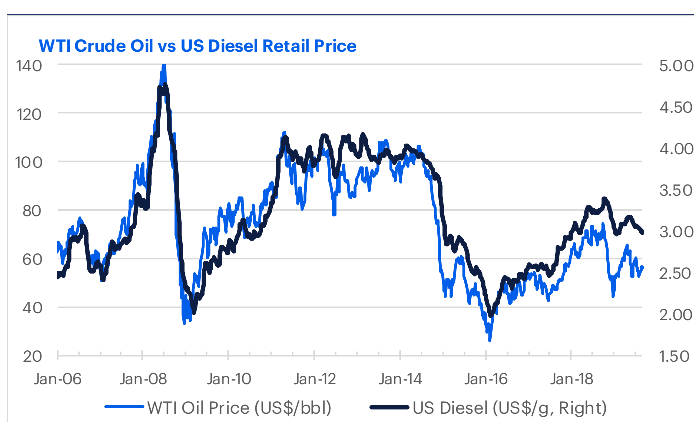
Anaemic top-line growth

- Analysis of the earnings reports of the Top 20 companies shows top-line growth (in reporting currency) slowed to 2.7% YoY (see Figure 6). Only four companies achieved double-digit growth:
  - Macquarie Group – explosive growth in its Markets and Capital divisions, with modest growth in its annuity businesses;
  - Goodman Group – booming growth in its Funds Management division, driven by AUM, up 22%, and large performance fees;
  - Transurban – acquisitions and contracted toll increases; and
  - CSL – double-digit growth in IVIG, Albumin and Sequiris sales.
- The anaemic overall growth for the top 20 reflects the moderation in Australian real GDP growth to around 28-year lows of 1.4% YoY and the associated deterioration in business sentiment. More specifically, the financials are facing very slow loan growth, pressure on net interest margins and fees, and a moderation in insurance premium inflation. Consumer-facing stocks are seeing sluggish same-store retail sales growth. Telstra is facing pressure from declining fixed-line revenues, a margin squeeze from the rollout of the NBN and even revenue declines within some of its growth initiatives (NAS and data). Positive revenue growth at BHP and Rio Tinto was driven by surging iron ore prices, but production disruptions and soft base metals prices curtailed overall growth.
- Looking ahead, we expect this anaemic growth to continue. Whilst moderate rate cuts, the low and middle income tax offset (LMITO) and higher bulk commodity prices are supportive of growth, the downturn in housing activity, pressure on squeezed households, stall-speed risks and several emerging headwinds – the tapering off of the ramp-up of LNG volumes and infrastructure investment, the completion of the NBN and NDIS rollouts and collapsing stamp duty revenues – should contain any near-term recovery.

Flat operating profit

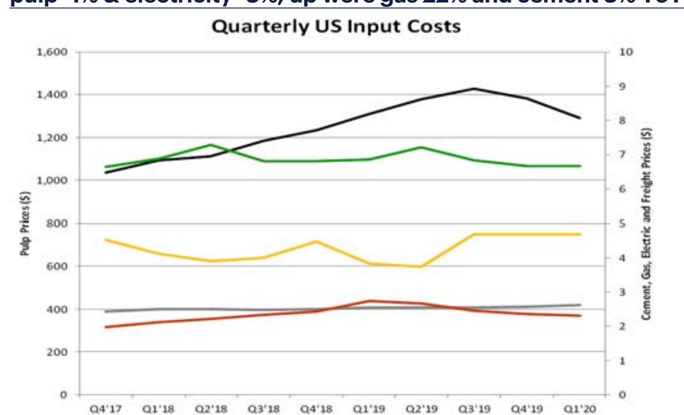
- Despite the anaemic top-line growth, strong cost control meant that companies were able to contain the damage to operating margins, meaning that operating profit for the top 20 fell just 0.5% YoY (see Figure 6 again).
- Labour cost pressures appear moderate, with Australia's wage cost index up 2.3% YoY, up from 2.0% YoY a year ago, but still well below the long-term average 3.2% YoY. While total employment is up a strong 2.6% YoY, this is being driven by the public sector and household services, with little private business employment growth.
- Non-labour input cost pressures should be moderating. Oil and diesel prices have softened versus year ago levels, with Brent falling ~7% YoY (in USD) and tracking down at a mid-teens rate so far in 3Q19, whilst US diesel prices were marginally lower in 1H19 and are tracking down mid-single digit so far in 3Q19 (Figure 2). In the US, freight and lumber/pulp costs seem to be moderating, a positive for James Hardie (Figure 3). We were surprised at the comments regarding ongoing, albeit moderating, cost pressures by Brambles.

Fig.2: Lower oil prices should ease fuel cost pressure



Source: Datastream, EL&C Baillieu

Fig.3: JHX input cost pressures: Down includes freight -16%, pulp -1% & electricity -3%; up were gas 22% and cement 3% YoY



Source: Company presentation

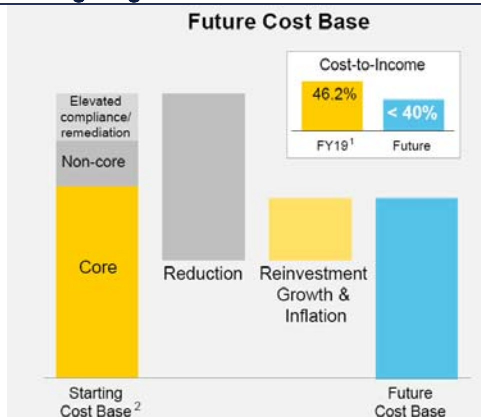
Scarcity of pricing power

- It is increasingly difficult to find companies able to lift prices. Whilst inflation in food retailing has picked up, this appears to be drought-driven more than a shift in competitive intensity. Kaufland's entry into the market in 2021 should ensure the improvement is temporary. Elsewhere, global insurer QBE continues to lift premium pricing, up 4.7% YoY in 1H19. Brambles has managed to improve pricing, but this reflects recovery of past input cost increases.

Cost-cutting is back

- Struggling for top-line growth, many ASX 200 businesses are returning to cost-cutting. Examples amongst major businesses include:
  - CBA outlined a cost reduction strategy targeting a cost-to-income ratio below 40% versus FY19's 46.2% (Figure 4). A similar strategy is being pursued by all the major banks.
  - IAG optimisation program with a target of $250m, versus $90m achieved to date.
  - Telstra achieved $1.2bn of $2.5 billion target by FY22.
  - Tabcorp achieved $68m of synergies from the Tattersalls acquisition, with a target of $130-150m by FY21.
  - Star Entertainment – a rapid $40-45 million cost-cutting program
  - Virgin Airlines – $75m in cost savings from removal of 750 (30%) corporate jobs.
  - Caltex – $100m cost-out program by 2020 and the divestment of ~50 sites.

Fig.4: CBA is targeting a cost-to-income ratio below 40%



Source: Company reports

Fig.5: Major capital management initiatives in FY19 results

Name	Security	Forecast Special Dividends ($m)	Off-market buybacks/ capital return ($m)	Total distributions ($m)
RIO	Rio Tinto Limited	329		329
CCL	Coca-Cola Amatil	29		29
COL	Coles Group	153		153
TLS	Telstra Corporation.	357		357
MPL	Medibank Private Ltd	69		69
ASX	ASX Limited	250		250
WHC	Whitehaven Coal	174		174
QAN	Qantas		400	400
		1,361	400	1,761

Source: Company reports, EL&C Baillieu

Fig.6: ASX top 20 reporting season: Anaemic growth

	Underlying NPAT			Revenues/ Income			Operating Profit/PPP				Constant Currency	
	F19	F18	YoY%	F19	F18	YoY%	F19	F18	YoY%	EPS YoY%	Sales YoY%	OP YoY%
Financials												
ANZ	3478	3407	2.1%	9553	9510	0.5%	5293	5216	1.5%	4.5%		
CBA	8492	8915	-4.7%	24132	24686	-2.2%	13142	13927	-5.6%	-5.8%		
IAG	871	947	-8.0%	12005	11647	3.1%	1224	1407	-13.0%			
Macquarie	2982	2557	16.6%	12754	10920	16.8%	3867	3464	11.6%	16.5%		
NAB	3279	3290	-0.3%	9218	9093	1.4%	5163	5104	1.2%			
Suncorp	1115	1098	1.5%	11024	10800	2.1%	1624	1639	-0.9%			
Westpac	4049	4262	-5.0%	10915	11239	-2.9%	5958	6548	-9.0%	-6.0%		
Consumer												
Wesfarmers	1940	1709	13.5%	27920	26763	4.3%	2974	2650	12.2%	13.5%		
Woolworths	1752	1605	9.2%	59984	56944	5.3%	2724	2548	6.9%			
Industrials												
Amcor	730	697	4.7%	9458	9319	1.5%	1394	1390	0.3%		5.5%	4.1%
Brambles	454	554	-18.0%	4595	4470	2.8%	1288	1290	-0.2%		7%	2%
CSL	1919	1729	11.0%	8539	7915	7.9%	2504	2380	5.2%		11%	8%
Transurban	260	489	-46.8%	2581	2340	10.3%	2016	1796	12.2%	0.5%		
REIT's & Utilities												
Goodman	942	846	11.3%	3026	2673	13.2%	1090	949	14.9%	10.5%		
Scentre	676	657	2.9%	1303	1282	1.6%	873	835	4.6%		1.5%	
Telstra	2000	2600	-23.1%	27800	28500	-2.5%	7800	8700	-10.3%			
Resources												
BHP	9466	9622	-1.6%	44288	43129	2.7%	23158	23183	-0.1%	4.8%		
Rio Tinto	4932	4416	11.7%	21809	21217	2.8%	10250	9198	11.4%	18.9%		
S32	992	1327	-25.2%	7274	7549	-3.6%	2197	2516	-12.7%	-23.3%		
Woodside	419	566	-26.0%	2260	2388	-5.4%	1462	1718	-14.9%	-24.8%		
Average	50748	51293	-4.0%	310438	302384	3.1%	96001	96458	0.7%			
Median	-1.1%		-0.3%	2.7%		2.7%	-0.5%		0.3%			

Source: Company reports, EL&C Baillieu

Capital management moderates

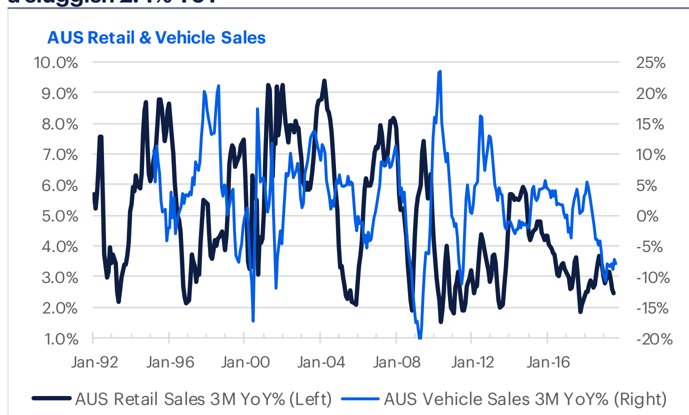
- Announced special dividends and buybacks were more subdued this reporting season relative to the elevated level of capital returns in 1H CY19, with approximately $1.8 billion 'new' distributions announced. Key announcements included:
  - Coca-Cola Amatil declared a special dividend following the sale of its SPC business;
  - ASX declared a special dividend funded by the sale of its stake in IRESS;
  - Medibank announced a special dividend as it lowered its capital range from 12-14% to 11-13%;
  - Telstra continued to receive one-off NBN receipts from the roll-out of the NBN, and again declared a special to payout a portion of the receipts;
  - Rio Tinto declared a special dividend following strong realised iron ore prices;
  - Whitehaven Coal also declared a special dividend, driven by commodity prices;
  - Coles Group declared a special dividend to distribute earnings from the stub period following its divestment from Wesfarmers;
  - Qantas announced an off-market buyback of approximately $400 million to distribute surplus capital and franking credits;
  - Fortescue Metals declared a 24 cent dividend, up 100% YoY, though down versus 1H19;
  - Suncorp announced a c.$506m pro-rata capital return, subject to approval – equivalent to 39 cents per share – as previously flagged following the sale of its life insurance business;
  - Brambles reaffirmed its intention to return c.US$0.3bn in cash equivalent, or A$0.29 per share, in addition to its US$1.65bn on-market buy-back program following the sale of its IFCO RPC business.

Looking forward: Indicators generally soft; RBA/tax rebate to the rescue?

- Current commentary from major companies was mixed, but with some signs of improvement. Examples included:
  - Harvey Norman LFL sales +3% year-to-date, versus -0.9% YoY in FY19;
  - Flight Centre – signs of stabilisation in the Australian leisure market;
  - Carsales.com – a solid start to FY20;
  - JB Hi-Fi – July same-store sales at JBH was 3.2% versus 2.8% in FY19; at Good Guys was -3.4% versus 0.9% in FY19;
  - Virgin Australia – challenging trading conditions continuing in 1Q.
- FY20 guidance was generally sluggish, continuing the trend of FY19 – ranging from guided declines at the likes of Telstra, Boral and Challenger to solid increases at CSL and Cochlear;
- Key drivers of activity and profits in different sectors of the economy have generally moderated and are soft, with the notable exception of the established property market.
- **Consumer: A broad-based slowdown, yet to respond to the RBA/tax cuts:**
  - **New vehicle sales – weak**, with the three months to August down 7.9% YoY and year-to-date down 8.0% YoY (Figure 7).
  - **Retail sales – sluggish**, with the three months to July up just 2.4% YoY and year-to-date 2.8% YoY (Figure 7). Excluding supermarket sales, sales are even slower at 1.9% YoY (3MMA) and year-to-date 2.0% YoY.
  - **Tourist arrivals and returns – decelerating**, with arrivals and returns moderating to 3.7% YoY and 2.9% YoY respectively (2Q19) versus year-to-date arrivals up 2.6% YoY and returns 3.1% YoY.
  - **Consumer confidence – softening**, with the three months to September down 5.0% YoY and year-to-date down 3.0% YoY.

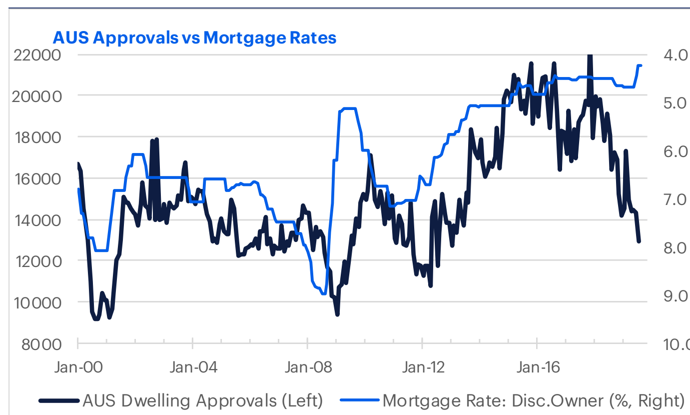
- **Housing-related: A deep downturn in activity, but established prices possibly recovering:**
  - **Dwelling approvals – extremely weak**, with the three months to July down 24.1% YoY in 2Q19 and year-to-date down 22.6% YoY (Figure 8).
  - **Housing finance – possibly recovering**, with a 4.2% MoM bounce in owner-occupier finance ex-refinancing in July, though it remains down 12.4% YoY. Investor ex-refinancing bounced 4.7% MoM, but remains down 24.1% YoY.
  - **Home prices – possibly recovering,** with CoreLogic prices in the capital cities up 1.0% MoM in August and 1.0% over the quarter, though down 5.9% YoY.

Fig.7: Vehicle sales are down 7.9% YoY, whilst retail sales are up a sluggish 2.4% YoY



Source: Datastream, EL&C Baillieu

Fig.8: Dwelling approvals are down 24.1% YoY



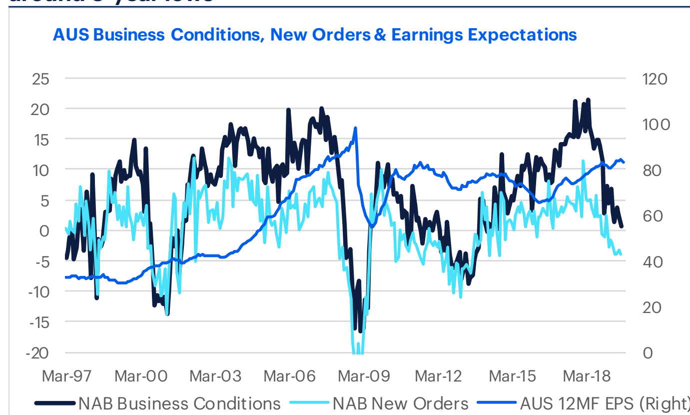
Source: Datastream, RBA, EL&C Baillieu

- **Business-related: A softening of sentiment to below-average levels**
  - **NAB business sentiment – deteriorating:** Confidence in August fell to a below-average +1, unwinding a post-election and RBA rate cuts bounce, and down from +6 a year ago (Figure 9). Business conditions are also a below-average +1, down from +15 a year ago, and new orders are a weak -4, down from +6 a year ago (Figure 10). This should be consistent with sluggish-to-soft business investment.

Fig.9: AUS business confidence has unwound a post-election and rate cuts bounce, and is around five-year lows

Source: Datastream, EL&C Baillieu

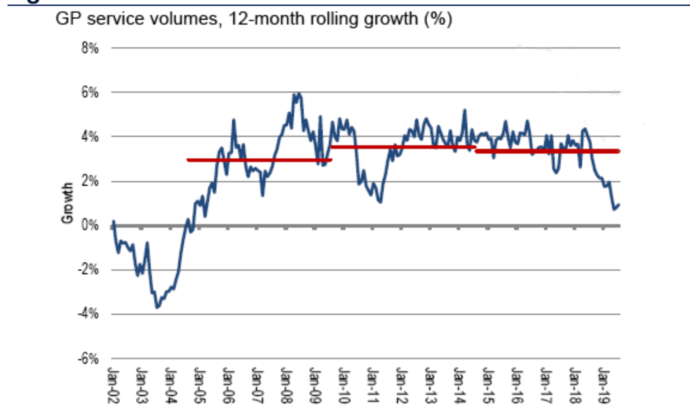
Fig.10: AUS business conditions and new orders have fallen to around 6-year lows



Source: Datastream, RBA, EL&C Baillieu

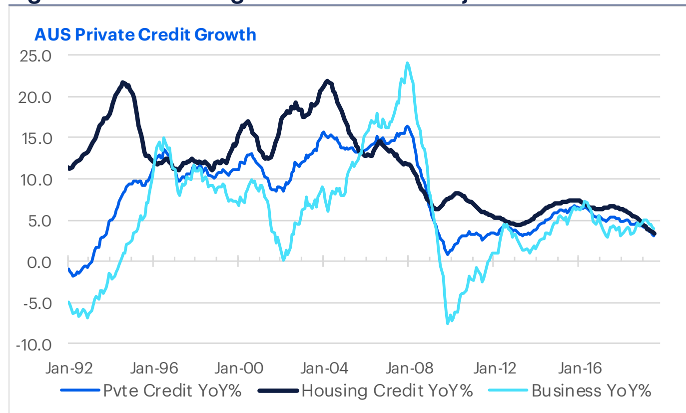
- **Health-related: Sluggish growth, with falling private health insurance**
  - **Private health insurance coverage – declining**: The number of people insured fell 0.6% YoY in 2018, lowering the insurance coverage ratio to 44.6%, down 2.7ppts.
  - **Diagnostic services – sluggish:** Year-to-July pathology volumes are up 1.9% YoY, below the five-year average 2.9% YoY. Similarly, year-to-July GP visits are up just 0.9% YoY, well below the five-year average 3.4% YoY (Figure 11).
- **Finance-related: Decelerating**
  - **Private credit growth – decelerating:** Credit growth over the three months to July has slowed to a multi-year low 3.3% YoY, down from 4.6% YoY a year ago (Figure 12). Housing credit growth was a record low 3.5% YoY, down from 5.7% YoY a year ago.
  - **Australian dollar – weaker (a tailwind for profits):** The AUD/USD has averaged 69.0 cents over the past three months, down 6.6% YoY. Versus the pound and euro the decline is a more moderate ~2% YoY and ~3% YoY respectively.

Fig.11: GP visits have slowed to 0.9% YoY



Source: Medicare, EL&C Baillieu

Fig.12: Private credit growth has slowed to just 3.3% YoY



Source: RBA, EL&C Baillieu

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