EL&C Baillieu
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Australian Strategy Insight

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Investment Strategy

AGM season: Early trends remain sluggish

The ASX 200 remains robust, trading just below its record high and on an unusually high forward PE of ~16.5x, ~14% above average. But the earnings picture looks very different, with the trends of the FY19 reporting season – where earnings fell ~2% YoY – appearing to continue into the AGM season.

Themes of this AGM season appear to be anaemic top-line growth, elusive pricing power and generally cautious outlooks, though some companies expect a 2H upturn. Economic indicators in 3Q19 are also subdued.

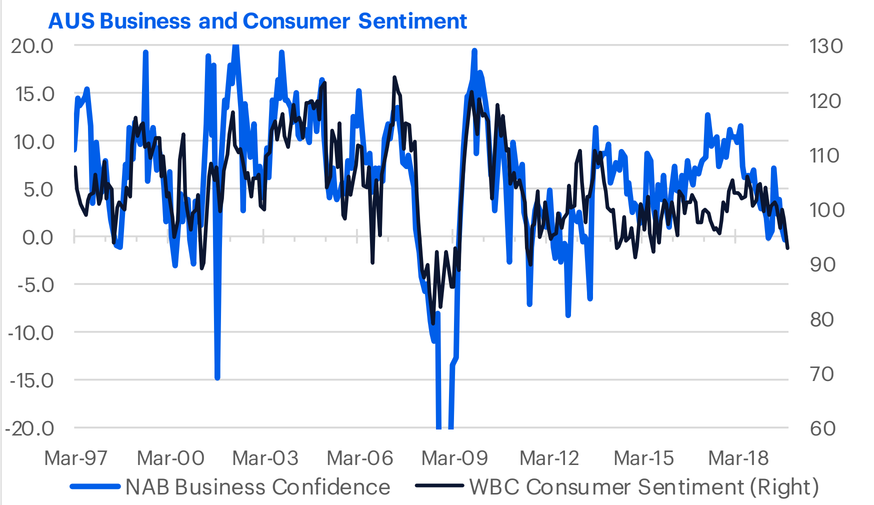
Whilst still inconclusive, to-date the rate and tax cuts have gained little traction outside the established property market. Unless this changes, we expect flat profits in FY20, well below consensus estimates of ~11% YoY growth.

Key sector trends from this AGM season include:

- Gaming – casinos top-line growth a sluggish 2% YoY, or lower.
- Industrials – weak activity, with flat-to-lower volumes and domestic pricing pressure in airlines. By contrast, Brambles had a better quarter.
- Retail – mixed, but generally sluggish, with increased promotional activity noted by Super Cheap and Kathmandu. JB Hi-Fi outperformed, again.
- Property – signs of some improvement in residential noted by Stockland and Mirvac. Retail mall sales growth has generally remained sluggish around 2-2.5% YoY
- Materials and Energy – profit pressure from falling prices, be it fertilisers, graphite or coal, as well as some production problems.
- Financials – increased customer remediation from the major banks, but elsewhere soft income and fund outflows.

Investment implications: Sluggish growth implies flat profits in FY20, well below consensus estimates for ~11% YoY growth. If so, forecasts of profit rebounds for the banks, industrials and consumer sectors seem aggressive.

Fig.1: AUS business and consumer sentiment has softened the election surprise, rate and tax cuts, pointing to sluggish profits performance



Source: Datastream, EL&C Baillieu

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AGM season: Early trends remain sluggish

- The ASX 200 remains robust, trading just below its record high and on an unusually high forward PE of ~16.5x, about 14% or 1.0 standard deviation above its long-term average. But the earnings picture looks very different. Following an FY19 reporting season where earnings fell ~2% YoY, we recently entered the Annual General Meeting (AGM) season, where companies often release trading updates (for 1Q or year-to-date trading) and provide FY20 guidance. So far this AGM season appears to be continuing the sluggish trends apparent in the FY19 reporting season. Themes of this AGM season appear to be anaemic top-line growth, elusive pricing power and generally cautious outlook statements, though some companies are expecting a 2H upturn. Economic indicators of activity in 3Q19 also point to a continuation of subdued growth. Whilst still inconclusive, the early indicators suggest that the 75bps of rate cuts and tax rebates have gained little traction outside the established property market. Unless stimulus gains traction, we remain of the view that another year of flat profits is in store for the Australian market, well below consensus estimates of ~11% YoY growth.

Anaemic top-line growth and elusive pricing power

- Analysis of 1Q20 trading updates and commentary associated with AGMs points to ongoing anaemic top-line growth and elusive pricing power from a range of sectors:

- **Gaming: Sluggish sub-2% top-line**
  - Star Entertainment (SGR) – domestic year-to-date revenues up 1.5% YoY, with VIP rising (though on a low win rate); and
  - Crown (CWN) – domestic main floor +2% YoY and non-gaming flat, whilst VIP has fallen 46% YoY (with a better win rate).

- **Industrials, Transport and Infrastructure: Sluggish, or worse, activity**
  - Cleanaway (CWY) – profit warning, reflecting weak economic activity, soft commodity prices and lower Queensland volumes (new landfill levy);
  - GWA (GWA) – pro-forma 1Q revenue down 8% YoY due to destocking and deteriorating market conditions in new housing and renovations;
  - Qantas (QAN) – 1Q revenue up 1.8% YoY, with unit revenue up 2.1% YoY, though domestic unit revenues fell 0.9% YoY. Consistent with this, Virgin Airlines (VAH) has referred to challenging trading conditions in 1Q;
  - Cimic (CIM) – year-to-date revenues flat, and declining cash-flow, though work-in-hand is up 6% YoY;
  - Atlas Arteria (ALX) – 1Q volumes fell 0.6% YoY, though toll revenues rose 1.7% YoY;
  - Sydney Airport (SYD) – total September quarter traffic about flat year-on-year, with domestic down modestly;
  - Aurizon (AZJ) – 1Q coal volumes up 1% YoY;
  - Transurban (TCL) – total 1Q volumes up 1.8% YoY, but Sydney ex-M4 up just 0.1% YoY (total 2.1%YoY), Melbourne 0.6% YoY and Brisbane 2.7%YoY, on the back of the Logan and Gateway North upgrades; and
  - Brambles (BXB) appears to be the exception, with 1Q revenues 5% YoY in constant currency (2% YoY reported) and reaffirming guidance.

- **Consumer: retail mixed, but generally sluggish, with some pressure on gross margins**
  - JB Hi-Fi (JBH) – 1Q like-for-like (LFL) sales mixed, with JB Hi-Fi Australia 3.7% YoY (prior comparable period 3.4%), Good Guys -1.8% YoY (+1.0%pcp) and JB Hi-Fi New Zealand 3.8% (9.8%pcp);
  - Adairs (ADH) – year-to-date LFL slowed to 3.3% YoY vs 7.2% in FY19;
  - Super Retail Group (SUL) – year-to-date LFL 3.2% versus 2.9% YoY, but on the back of increased promotional activity which has adversely affected margin;
  - Event Hospitality (EVT) – Cinema appears to be an exception. Total 1Q operating profit rose 9% YoY, led by Cinema box-office revenue up 12%, whilst Hotels were flat in a challenging market and Thredbo was mixed with profit down slightly;
  - Inghams (ING)– profit warning due to high feed costs and a disappointing plant rationalisation program;
  - ARB (ARB) – profit warning with a falling 1H profit on the back of lower vehicle sales and a strong Thai baht;
  - Nick Scali (NCK) – profit warning with year-to-date LFL sales down 8% YoY, on a 10-15% decline in store traffic;
  - Southern Cross (SXL) – profit warning driven by an 8.5% YoY decline in 1Q revenues, with ad markets "short and volatile";
  - Flight Centre (FLT) – profit warning on the back of Australia leisure remaining challenging, as well as negative impacts from Brexit, wage increases, falling interest earnings and the Thomas Cook collapse; and
  - Kathmandu (KMD) – First seven weeks' LFL in Australia 4.0% YoY (versus 2.7% in FY19) and New Zealand 11.7% YoY (-3.9% in FY19) on a lower gross margin.
- **Property: Improving tone in residential, but generally sluggish retail mall sales**
  - Stockland (SGP) – residential net deposits down 11% YoY but up 36% QoQ, with enquiry levels improved and defaults moderating. Within its Retail division, moving annual turnover (MAT) picked up from 2.3% YoY in June to 2.6% YoY in September (specialty stores up 0.3ppt to 2.1% YoY);
  - Mirvac (MGR) – residential poised at the bottom of the cycle, with settlements on track for FY20. Within its Retail division, MAT moved sideways at 2.6% YoY versus 2.7% in June (specialty stores sideways at 2.0%YoY); and
  - Vicinity (VCX) – Retail MAT moved sideways at 2.6% YoY in September versus 2.7% YoY in June (specialty stores picked up 0.3ppt to 2.0% YoY)
- **Materials and Energy: Profit pressure from falling prices and some production problems**
  - Oil Search (OSH) – production guidance downgrade on the back of mooring buoy damage;
  - St Barbara (SBM) – profit warning from reduced gold production guidance;
  - Orora (ORA) – subdued trading continuing;
  - Coronado Coal (CRN) – profit warning on the back of a 40% year-to-date decline in met coal prices;
  - Sims Metal Management (SGM) – profit warning on the back of lower scrap metal prices given the trade war and freight costs;
  - Syrah Resources (SYR) – profitwarning on a sudden and material decline in prices in China; and
  - Incitec Pivot (IPL) – profit warning on the back of falling DAP and ammonia prices, as well as falling ammonia production, rising gas costs and the drought.

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- **Financials: Further customer remediation costs, and pressure on income-**
  - Increased customer remediation payments from the major banks, including National Australia Bank (NAB) at $832 million (plus a $494 million software write-off), Australia and New Zealand Banking Group (ANZ) at a $559 million after-tax charge, and Westpac (WBC) $341 million;
  - Bank of Queensland (BOQ) – FY19 profits fell 14% YoY, with income down 2% YoY; the company guided FY20 to a decline, reflecting flat income, but rising compliance and technology costs;
  - Steadfast (SDF) – upgrade, with profits tracking to the top-end of guidance; and
  - Funds managers – persistent funds outflows in 1Q, including AMP (-$1.9 billion), Pendal (-$2.3 billion), Perpetual (-$1.8 billion) and Platinum (-$0.8 billion), with the exception of Magellan Financial Group (+$1.35 billion).

Profit warnings

- As noted above, since early September a wide range of companies have announced profit warnings (Figure 2).

Fig.2: ASX AGM season profit warnings

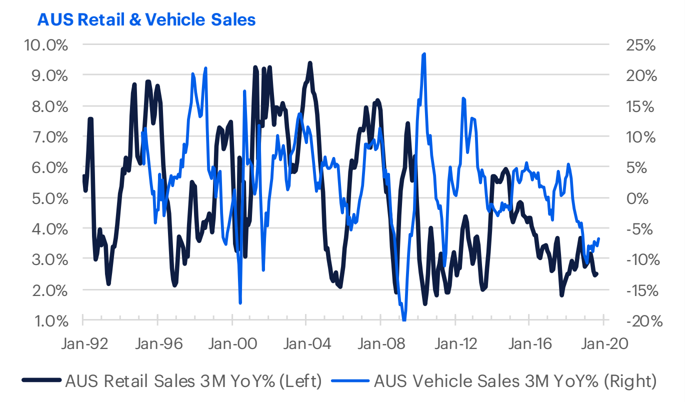
Name	Date	Commentary
Communication Services		
Southern Cross Media	15 Oct	1H20 EBITDA guidance of $60-68m below 1H19 of $82m and 1H18 of $80m - Weak media mark
Consumer Discretionary		
Flight Centre	9 Oct	1H20 profit guidance below 1H19. Weak AU trading conditions. Global uncertainty. Eg. Brexit. Higher labour costs from new wage model and consultancy costs.
ARB Corporation	17 Oct	Declining new car sales and weaker AUD relative to Thai Baht impacting cost of Thai products - negative sales margin impacts. Likely that 1H20 profit less than 1H19.
Nick Scali	15 Oct	LFL store sales down 8% YTD, lower retail demand, slowdown in housing sales and renovations. 1H20 NPAT guidance $17-19m down from 1H19 $25m
Consumer Staples		
Inghams	17 Oct	Reiterated lower FY20 EBITDA guidance- 1H20 EBITDA lower than 2H19 - high input (feed) costs driven by dry conditions in Australia in FY19
Financials		
NAB	2 Oct	$1.18bn additional charges related to remediation (c.$832m)and a change to software capitalisation, reducing 2h19 cash earnings by c. 1.123m
Westpac	23 Oct	2H19 cash earnings will be reduced by c.$341m - remediation costs. FY19 notable items c.$1,1
Industrials		
Cleanaway	25 Oct	1H20 earnings expected to be in line with 1H19 -lower economic activity & soft commodity prices vs 1H19 and reduction in QLD volumes.
Materials		
St Barbara	16 Sep	1H20 will be "materially lower" than 1H19 due to recent "significant falls in ferrous and non-ferrous prices" - trade war continues to reduce demand for steel and aluminium
Syrah Resources	10 Sep	Due to decrease in graphite price in China, SYR has reduced Q4 production volumes, SYR estimates post tax PPE and mining asset impairment of c.US$60-70m and inventory write-
Incitec Pivot	2 Sep	FY19 EBIT revised down to $$285-295m from $370-415m due to lower ammonia production, lower fertilisers earnings due to drought in NSW & QLD and increased gas costs.
Coronado	25 Sep	FY19 EBITDA guidance revised down to $687-737m from $737-807m due to lower met coal

Source: Company reports, EL&C Baillieu

Economic indicators: Generally soft, consistent with Company commentary

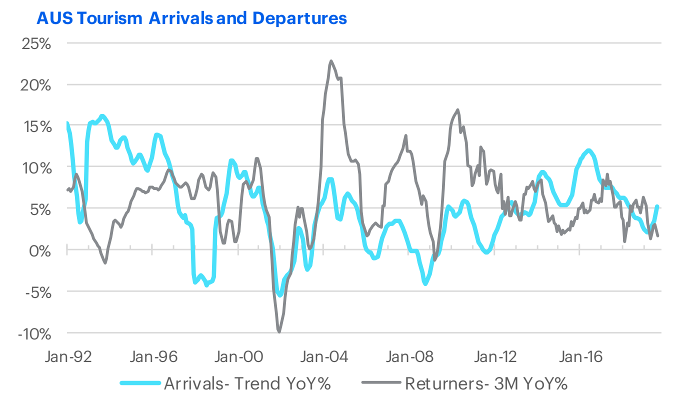
- **Consumer: Sluggish, yet to respond to the rate and tax cuts:**
  - **New vehicle sales – weak**, with the September quarter down 6.7% YoY and year-to-date down 7.9% YoY (Figure 3).
  - **Retail sales – sluggish**, with the three months to August up just 2.5% YoY and year-to-date 2.8% YoY (Figure 3). Excluding supermarket sales, sales are even slower at 1.9% YoY (3MMA) and year-to-date 2.0% YoY.
  - **Tourist arrivals and returns – returns decelerating**, with three months to August arrivals and returns moderating to 3.6% YoY and 1.7% YoY respectively versus year-to-date arrivals up 3.0% YoY and returns 2.5% YoY (Figure 4).
  - **Consumer confidence – weak**, with the three months to October down 4.8% YoY and year-to-date down 3.6% YoY. The 8.4% decline in confidence since May is the worst reaction to an RBA easing cycle since at least 1980 (Figure 5).

Fig.3: Vehicle sales are down 6.7% YoY, whilst retail sales are up a sluggish 2.5% YoY



Source: Datastream, EL&C Baillieu

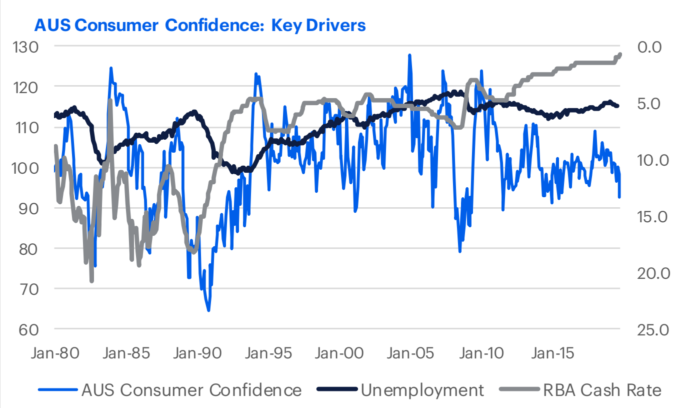
Fig.4: Tourist returners have slowed to just 1.7% YoY



Source: Datastream, RBA, EL&C Baillieu

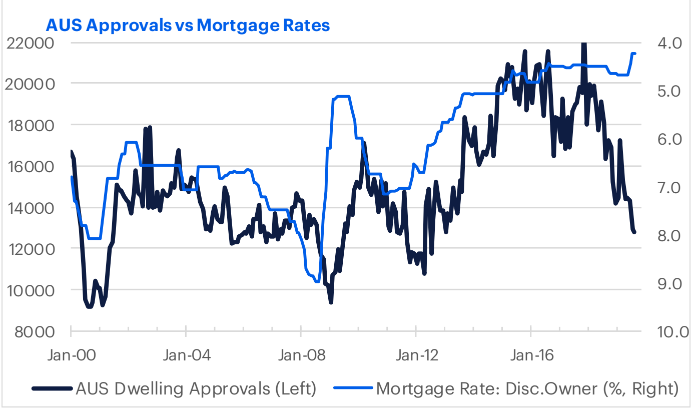
- **Housing-related: A deep downturn in activity; but established prices bouncing:**
  - **Dwelling approvals – very weak**, with the three months to August down 25.0% YoY and year-to-date down 22.1% YoY (Figure 6).
  - **Housing finance – rebounding**, with a 5.8% bounce in owner-occupier finance ex-refinancing over the four months to August, though it remains down 5.1% YoY. Investor ex-refinancing has bounced 11.6% since May, but remains down 13.0% YoY.
  - **Home prices – bouncing,** with CoreLogic prices in the capital cities up 2.2% over the September quarter, though still down 4.3% YoY.

Fig.5: Consumer confidence is down 8.4% since May, the worst reaction to an RBA easing cycle since at least 1980



Source: Datastream, EL&C Baillieu

Fig.6: Dwelling approvals are down 25.0% YoY



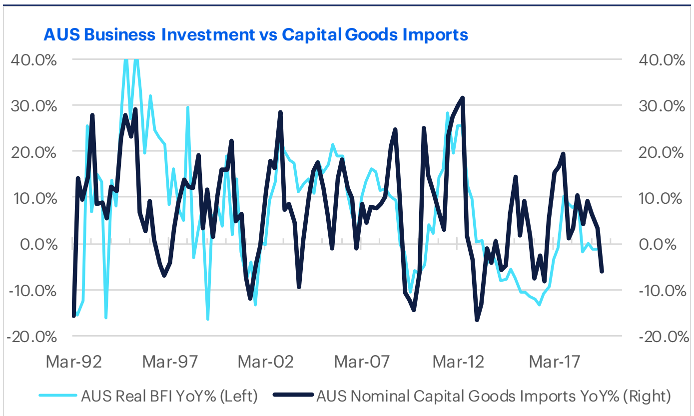
Source: Datastream, RBA, EL&C Baillieu

- **Business-related: softening sentiment and capital goods imports**
  - **NAB Business Sentiment – deteriorating:** Confidence in September fell to a six-year low – 0.8 of a standard deviation below average – fully unwinding a post-election and rate and tax cuts bounce, and down from +7 a year ago (Figure 1). Business conditions, trading and new orders are all soft (Figure 7), consistent with weak earnings trends
  - **Capital goods imports have softened,** and are down 6.2% YoY (Figure 8).

Fig.7: AUS business conditions and new orders have fallen to around six-year lows

Source: Datastream, EL&C Baillieu

Fig.8: AUS capital goods imports are down 6.2% YoY, consistent with soft business investment

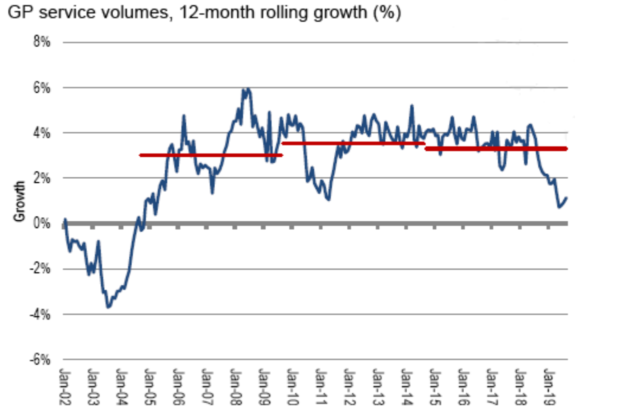


Source: Datastream, RBA, EL&C Baillieu

- **Health-related: Unusually sluggish growth**
  - **Diagnostic services – sluggish, decade-low growth rates across the board:** Year-to-August pathology volumes are up 2.5% YoY, below the five-year average 2.9% YoY. Similarly, year-to-July GP visits are up just 1.1% YoY, well below the five-year average 3.3% YoY (Figure 9). Imaging is up 2.4% YoY versus the average 4.4% YoY, and surgical volumes are up 1.0% YoY versus the 3.6% YoY average.
- **Finance-related: Decelerating**
  - **Private credit growth – decelerating:** credit growth has slowed to an eight-year low 2.9% YoY, down from 4.5% YoY a year ago (Figure 10). Housing credit growth was a record low 3.1% YoY, down from 5.4% YoY a year ago.

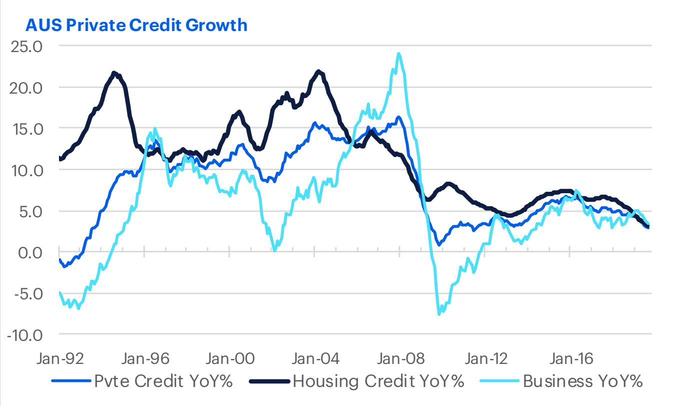
– **Australian dollar – weaker (a tailwind for profits):** The AUD/USD is tracking down 4.3% YoY (four-week year-on-year), but is only slightly lower versus the pound and euro (~1.1% YoY and ~0.7% YoY respectively).

Fig.9: GP visits have slowed to 0.9% YoY



Source: Medicare, EL&C Baillieu

Fig.10: Private credit growth has slowed to just 2.9% YoY



Source: RBA, EL&C Baillieu

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