Reporting Season Wrap & Outlook

March 2017

BT Investment Management

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This was a good reporting season with market EPS expectations increasing 1.6%, versus the usual average downgrade of -0.9%, the best outcome since 2010. Market EPS is now expected to grow 16% in FY17.

> **This is almost all a result of the turnaround in resources, however the stabilization of earnings in industrials was also a better than usual outcome.**

- Cost control was the key differentiator for industrial companies; results which demonstrated cost discipline to compensate for sluggish sales were generally well received.
- The market saw through lower quality results. Companies delivering poor cash flow or rising capital intensity tended to underperform.

> **The season lacked particularly strong broad-based 'themes', however there were key observations:**

1) Top 20 companies outperforming small caps

2) Companies surprising on capital return

3) Strategic responses by companies in disrupted industries showing signs of success

> **Market performance was reasonably strong across the season but, ironically, resources underperformed despite earnings strength. Banks did well on earnings upgrades, while a fall in US bond yields saw rate-sensitive equities do well.**

> **Looking forward, liquidity continues to support equity markets and valuations look reasonable, especially given the pick-up in earnings. Continued signs of improved global economic growth could see inflation pick up, which could support further rotation away from bond-sensitives and towards cyclicals within the market. Some companies are showing signs of a credible response to persistent disruptive threats. The upshot is that stock selection remains crucial.**

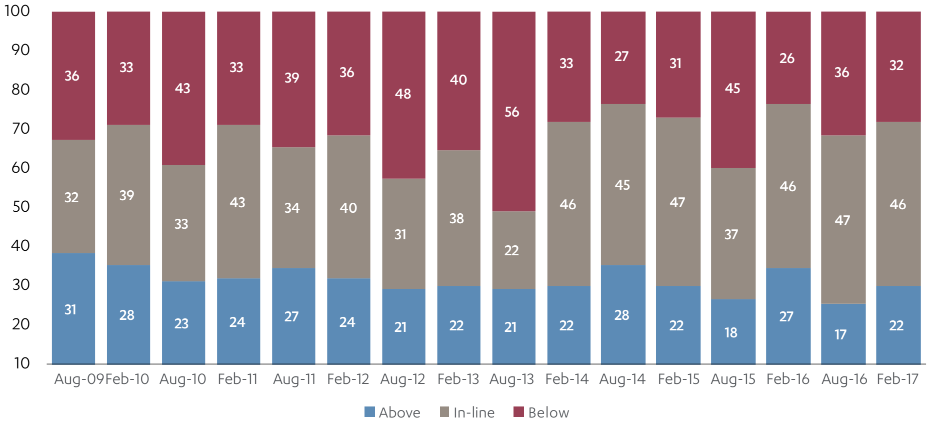
First half reporting: reasons for optimism

At a headline level, this reporting season provided several reasons for optimism with corporate Australia beginning to successfully adjust to the more subdued growth environment.

At first glance, the results do not deviate too far from historical norms. As per Chart 1, 22% of companies upgraded while 32% downgraded which, while better than last season, is broadly in line with the long-term average.

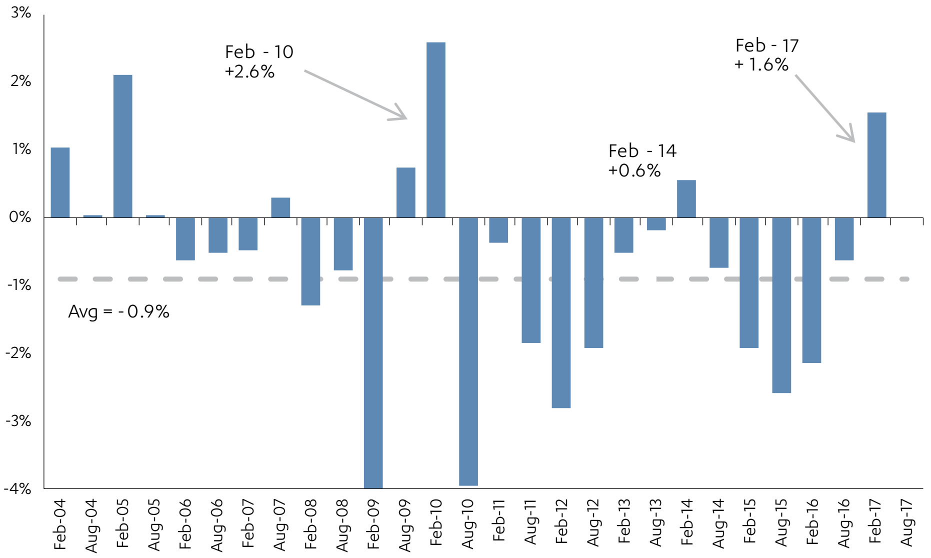
More telling is the change in aggregate expected earnings for the S&P/ASX 200 in FY 17, which increased by 1.6% as a result of reporting season. While this may not seem like much, it is the best result since February 2010 and stands in stark contrast to the average downgrade of -0.9% that follows reporting season (see Chart 2).

Chart 1: 3 month earnings revisions compared to consensus EPS



Source: Goldman Sachs, FactSet, Bloomberg

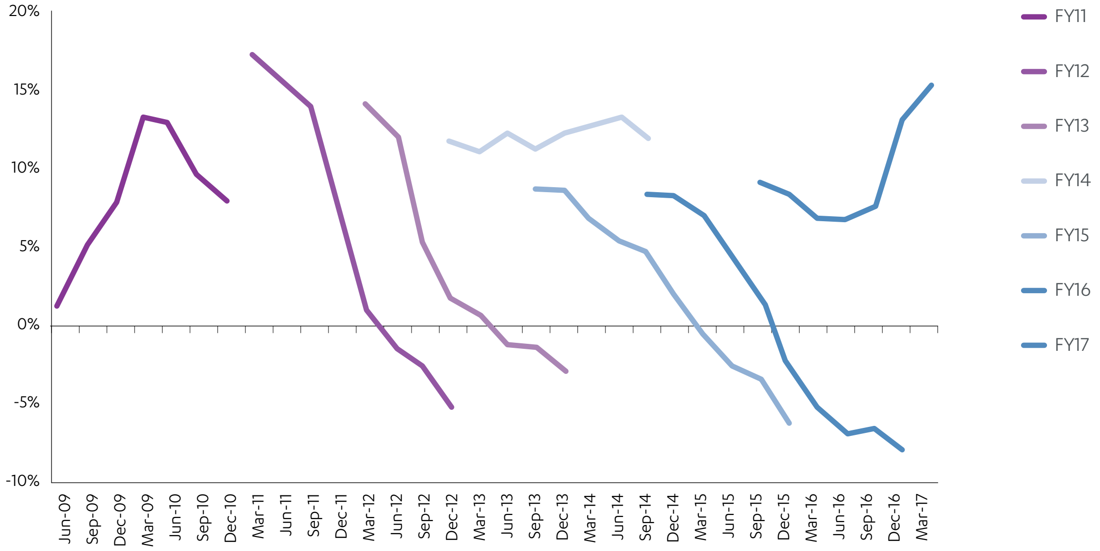
Chart 2: ASX 200 EPS upgrades/ downgrades for FY17



Source: Credit Suisse, Factset

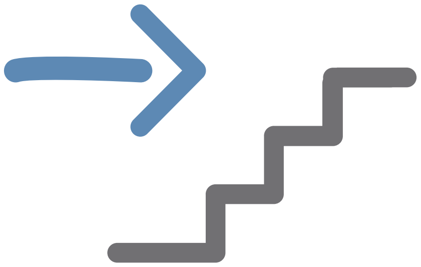
The upshot is that the ASX200 remains on track for its first financial year of positive EPS growth since FY14, with upgraded expectations now at 16% growth for FY17, following -13% in FY16 and -3% in FY15. This is a remarkable turnaround, given the market expected 8% EPS growth for FY17 as recently as August 2016. It is unusual to see an improvement in earnings expectations over the course of a year. As Chart 3 illustrates, we have not seen this since FY11 – the tail-end of the China boom.

Chart 3: Path of consensus EPS growth



Source: Credit Suisse, Factset

> **“It is unusual to see an improvement in earnings expectations over the course of a year.”**

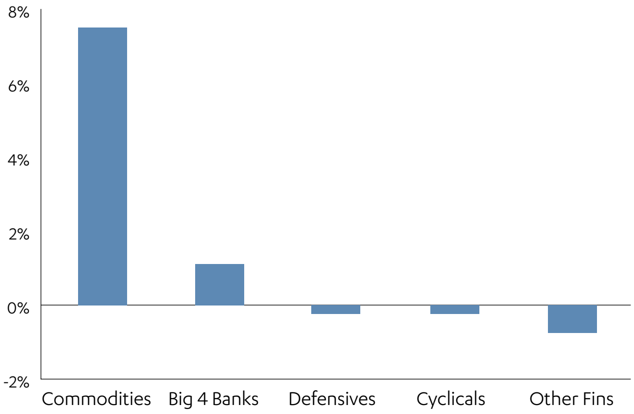


Resources resurgent

The caveat to all this positive momentum and earnings upside is that it was largely the result of a resurgent resource sector. Soft data at the end of 2015 saw the Chinese authorities administer an economic adrenaline shot via a credit injection and a renewed focus on infrastructure spending in early 2016. The result was an uptick in demand for resources which, in conjunction with supply disruption and discipline in iron ore and coal, have seen commodity prices soar. This, in turn, has seen a surge in cash flow and earnings for the miners, with their operational leverage enhanced by several lean years of cost cutting and, in some cases, near-death experiences. The turnaround has been spectacular, with cash flow funding debt reduction, dividends and buybacks, and share prices have surged accordingly.

The upshot is that we would caution against excessive exuberance regarding the turnaround in earnings; it is not broad-based (see Chart 4) and, while resource companies have been adept in controlling costs and capex, it has been the exogenous factor of commodity prices which has driven their success.

Chart 4: Earnings revisions by sector



Source: Credit Suisse, Factset

Commodity prices are constantly updated and easily available; it is the reason there are generally fewer real 'surprises' in resource company results and why earnings upgrades usually provide less impetus for stock price moves than might be the case for more opaque businesses and sectors. FY17 earnings expectations for resources were therefore already high, providing the swing factor between the -13% decline in FY16 earnings and the expected 16% gain in FY17. Nevertheless, many analysts continue to lag the market in terms of expected commodity prices, and resource earnings were upgraded by a further 5-6%, providing the bulk of the index's 1.6% upgrade.

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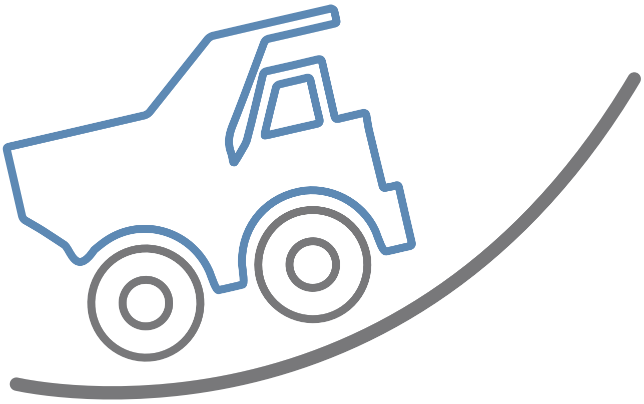
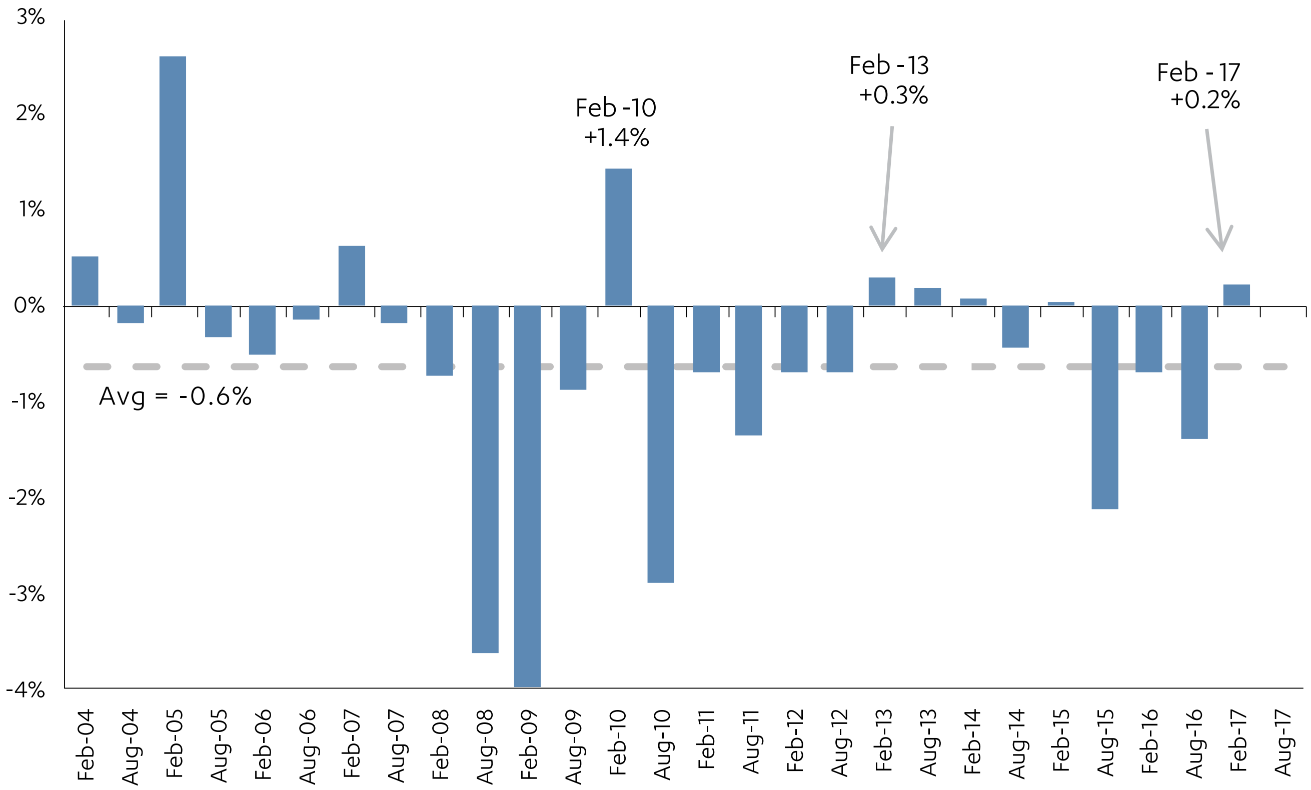


Industrials – less spectacular, but significant

Again, the turnaround in resources is well known and their results are not surprising given the strength of commodity prices. Beneath this, there is something perhaps more surprising and potentially more significant: that the market ex-resources (ie the industrials) did not, on the whole, disappoint.

The S&P/ASX 200, once commodity companies are removed, saw earnings expectations increase by +0.2%. Again, this does not seem much, but needs to be considered within the context of the average historical downgrade of -0.6% and the fact this is the best result since 2010 (see Chart 5).

Chart 5: ASX 200 ex commodities EPS upgrades/downgrades for FY17



Source: Credit Suisse, Factset

Cost discipline behind earnings upgrades

Earnings quality among the industrials was mixed. For all the nascent signs of optimism in this reporting season, we remain in an environment of muted revenue growth for most industries. Where companies beat expectations in this season, it was often a result of delivering surprisingly high levels of cost reduction. This was the case with Commonwealth Bank (CBA), which was able to limit cost growth to 1%, versus its usual run rate of 4-5%. While costs are growing, they are doing so less than revenue – which is running at 3-4% growth – thereby maintaining positive 'jaws' that can support earnings growth. Whilst ANZ delivered a trading update, rather than a result (ANZ's financial half ends in March), they flagged that they had actually managed to reduce costs 1%.

In combination with modest revenue growth from re-priced mortgages and a lower-than-expected impairment charge for bad-and-doubtful debts (BDD), this cost discipline saw bank EPS expectations upgraded 0.9%, to 2.9% for FY17. This is a long way short of spectacular, but is better than most recent expectations and assuages some of the fears which have weighed on bank stock prices at times over the past two years.

Qantas (QAN) too, provides a salient example in this vein. While it reported a 7.5% contraction in underlying pre-tax earnings due to the combination of softer domestic demand for much of 2016 and an increase in international industry capacity, the stock actually did well, as earnings were $25m ahead of the market consensus. Cost discipline has allowed QAN's earnings to be more resilient than the market expected and enabled them to continue to return capital to shareholders. There has been $1.6bn returned in the last 18 months, including an 18% reduction in the share count. With the current cost program concluding in June 2017, management have provided further targets on cost reduction beyond this, satisfying the market that this key pillar of QAN's turnaround remains intact.

Woolworths (WOW) has also surprised the market with how quickly it has been able to arrest the decline in like-for-like sales growth in the first half of the financial year which, supported by a reduction in shrinkage costs (eg food wastage), led to margins falling no more than feared. We remain cautious on WOW's chances of regaining the 5% profit margins that the current valuation implies, nevertheless management's strategy has at least halted its decline.

> **"Where companies beat expectations in this season, it was often a result of delivering surprisingly high levels of cost reduction."**

Show me the money – declining earnings quality drives underperformers

If cost discipline drove earnings upgrades and outperformance within industrials, it was any signs of declining cash flow or rising capital intensity which drove the season's underperformers. There was an uptick in companies relying on a range of accounting measures in order to hit earnings targets, such as the inclusion of one-off profits, release of provisions, changes to depreciation and amortization policies, or changes in treatment of working capital. As a result, the cash flow conversion of EBITDA was 67% - versus 83% in August 2016. However, this did not go unnoticed by the market and, in the underperformance of previous market favourites who showed signs of deteriorating quality, it is possible to discern a growing focus on cash flow, rather than accounting earnings.

This was illustrated in the market's strident reaction to Brambles (BXB), which fell over 10% in February following a profit warning in late January and results which fell well below its run rate of recent years. The issue here is the company has been guiding to aggressive growth targets for several years now, even as the fundamentals of their business deteriorated as competition intensified and management were forced to spend more in order to maintain their growth. In recent times, this has resulted in the need to resort to accounting measures, such as substituting capex for opex, in order to meet their earnings targets and justify the high valuation multiple to which they had been driven by a market keen for defensive growth. This opened up a gap between earnings and cash flow and set the scene for the profit downgrade in this year's 'confession season'. The market's reaction is yet another example in the litany of high-rated companies which have plunged on sometimes minor earnings disappointments over the last eight months.

Domino's Pizza (DMP) offers another interesting example: it increased FY17 earnings guidance from +30% to +32%, yet the stock fell in response as the market expressed concern over the amount of "one off" items and accounting measures which support earnings and, again, are driving a divergence between reported earnings and cash flow.

These examples highlight the need for investors to go beyond headline reported earnings to understand the underlying profitability of the business. Ultimately, accounting earnings can be manipulated, to an extent. Cash flow cannot, and often offers a far more accurate gauge of a company's true health and fortune.

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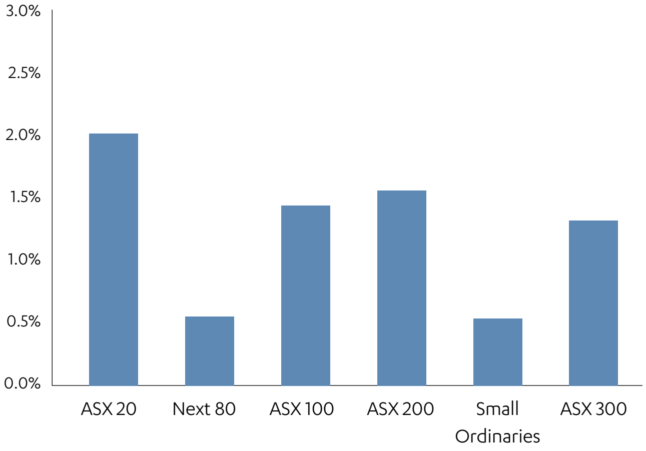
Themes

Theme 1: The Top 20 continues to outperform small caps

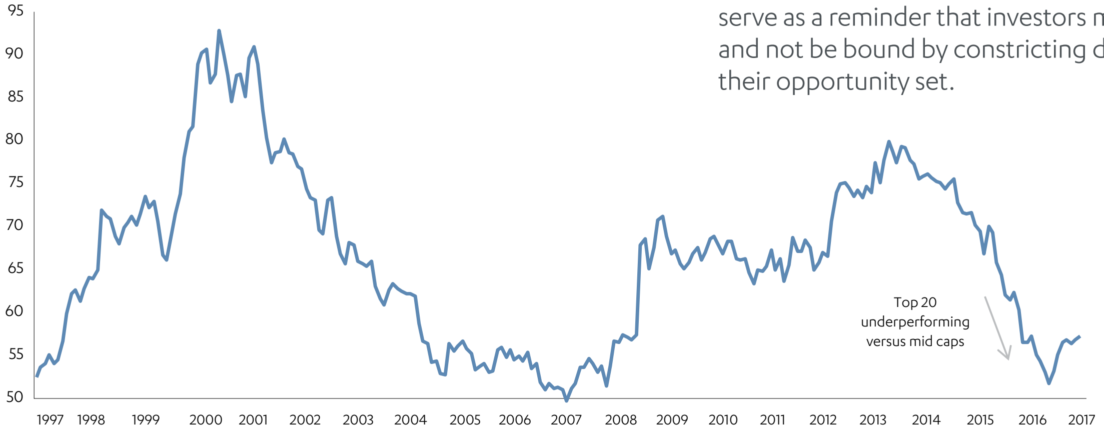
Given the observations discussed above, it is no surprise that it was large caps – and, specifically, the Top 20 - which provided the bulk of earnings upgrades via the 'Big Four' banks and the major commodity companies. The junior miners drove upgrades in the ASX 101-200, however it was interesting to note that midcaps lagged behind the rest of the market (see Chart 6).

Chart 6: Earnings revisions by stock size



Source: Credit Suisse, Factset

Chart 7: Relative performance of ASX 20 versus ASX MidCap 50 (20 years)



Source: Iress

Notwithstanding the banks and miners, the degree of offshore exposure could also be contributing to this divergence between the Top 20 and other parts of the market in terms of earnings momentum. While Australia's GDP expanded in Q4, managing to avoid a technical recession following the Q3 contraction, it is important to understand that this, too, was largely as a result of the commodity price surge. Demand in other parts of the economy remains sluggish and mining-driven centers continue to feel the hangover effects of the end in the mining capex boom. The US economy is looking stronger, in contrast, and there are a greater proportion of stocks within the Top 20 with exposure to it – and to other overseas markets – than is the case in mid and small caps. Top 20 companies which source a large proportion of their revenues outside of Australia include BHP Billiton (BHP) and Rio Tinto (RIO), CSL (CSL), Amcor (AMC), Woodside Petroleum (WPL), QBE Insurance (QBE), Westfield (WFD), while others such as Macquarie Group (MQG) have significant offshore exposure.

This earnings momentum is one of several factors which have seen a recent reversal of an almost five-year trend in the ASX Top 20 underperforming the ASX Midcap 50. As Chart 7 illustrates, this underperformance appeared to reach the bottom of a twenty-year cycle in August last year and has since started to reverse. We believe this retracement could continue, reflecting as it does a partial unwind of the surge of liquidity into midcaps in recent years in search of new ideas. We believe that midcaps continue to offer good opportunities for investment and growth. However, we reject the often accompanying argument that the Top 20 are somehow structurally moribund and it is impossible to make money in them. This chart - and the developments of this reporting season – serve as a reminder that investors must keep an open mind and not be bound by constricting dogma when assessing their opportunity set.

Theme 2: Companies surprising on capital returns

Dividend capitulation was a key theme of FY 2016 as companies cut payout ratios and abandoned progressive dividends in response to challenged revenues. The first half of FY17 has seen a stark reversal of this trend, with dividends per share growth coming in 2% ahead of expectations.

Again, this is not the result of a broad-based improvement. It was resources-led, with dividend growth 16% larger than expected, and driven by earnings as payout ratios remaining unchanged. Banks were the only other sector with positive dividend surprise.

Nevertheless, there was also a slew of companies across the market returning capital in the form of stock buy-backs. QBE Insurance (QBE) used one of its cleanest results in years to announce a 3-year buy back of $1bn, while Rio Tinto (RIO) ($500m buyback), Crown Resorts (CWN) ($500m), AMP (AMP) ($500m), Coca Cola Amatil (CCL) ($350m) and BSL ($150m) all got in on the act.

There is a cross section of Australian companies which have repaired their balance sheets following a challenging period, either through a sharp cash flow injection, the previous impairment of assets or the sale of others, or a combination of these. That several of these are now spinning capital back to shareholders suggests they lack growth opportunities, but on the positive side also implies there is a degree of confidence in their outlook.

Theme 3: The 'disrupted' fight back

In several instances, the surprise of a company's earnings upgrade was compounded by it having faced challenges, disruption or even 'near-death experiences' in the recent past. If we go back to 2014, Qantas, for example, was arguing for a government bailout in order to keep afloat. Bluescope Steel (BSL) actually received an assistance package from the NSW government in 2015 in order to keep its Port Kembla furnaces operational. At the same time, many in the industry were forecasting that iron ore miner Fortescue Metals (FMG) would collapse under the weight of plummeting iron ore prices, high costs and a huge debt pile.

Beyond this, Woolworths' recent fall from grace as it maintained excessive profit margin in the face of intensifying competition is well known while JB Hi-Fi (JBH) has also been under pressure in the face of online competition. The banks, too, provide good examples, with the combination of recent revenue pressure and regulatory requirement for increased capital leading to extremely depressed sentiment surrounding the sector.

This shows that some management teams are demonstrating the strategy and ability to react to adverse circumstances and start to reposition their business models. Where a company is able to reduce costs, it shows the resulting leverage to a cyclical upturn can see a turnaround take place faster than many would expect. It is often the combination of a good management team in a company or industry that has been written off by the market that provides some of the best opportunities for alpha.

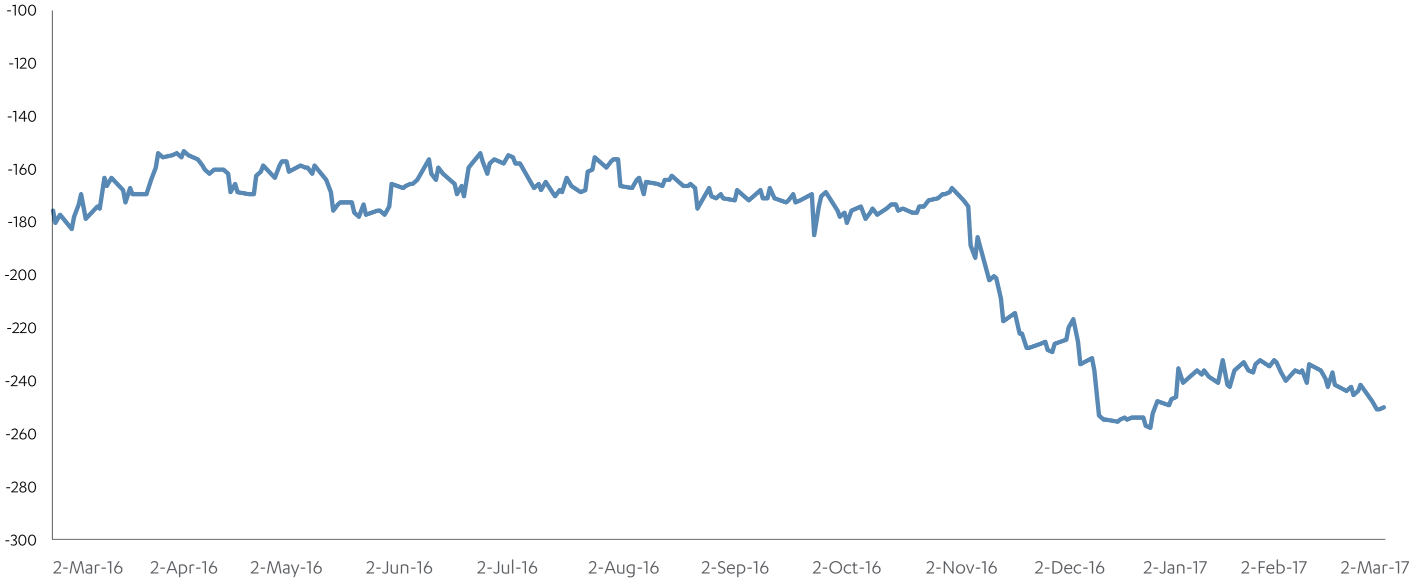
At the same time, there are still companies which are having to spend more just to stay still in terms of their market position, or who are struggling to rein in costs. As discussed above, the market is increasingly wary of companies displaying these trends. The lesson is that stock selection in this environment is of paramount importance.

Reporting season performance – resources go unrewarded

The season's greatest irony was that resources underperformed: the S&P/ASX 300 Resources index shed -3.3% versus a +2.2% gain for the broader market (S&P/ASX 300). Although individual results did drive some dispersion in performance during the month, the underlying and broader trends were driven by macroeconomic events. Ultimately, rate-sensitives such as REITs (+4.1%) and infrastructure tended to do well as US bond yields fell, reversing the trend of previous months, while cyclicals such as resources tended to struggle.

There were two primary contributing factors to the shift in bond yields. The first is tied to the performance of German bonds. As the French presidential election draws near – and the market grows wary of the chance, however slim, that the Euro-Skeptic Marine Le Pen might win - German bonds have been sought as a safe haven. As a result, the usual yield discount of German bunds to US treasuries widened to unusual levels – attracting capital into US bonds (see Chart 8).

Chart 8: German 5yr bond discount to US 5 yr Treasuries



Source: BTIM, Factset, March 2017

At the same time, fears emerged that the momentum of global growth may start to slow, which also saw a reversal in the bond yield decline. This was perhaps a natural reaction as the market's euphoria over the possible growth-friendly aspects of a Trump presidential agenda began to fade. Nevertheless, there was little in the data to suggest such a trend. It is important to understand that there were concrete signs of improved growth prior to President Trump's surprise victory, supported by a broad cross-section of data. There have been several other periods of improvement in the US economy post-GFC, however signs that US household balance sheets had healed since the GFC, as well as a normalization of wage growth, suggests that consumer confidence can help sustain this recovery (see Chart 9). While the Trump administration's policies could strengthen this improvement, it is not dependent upon it.

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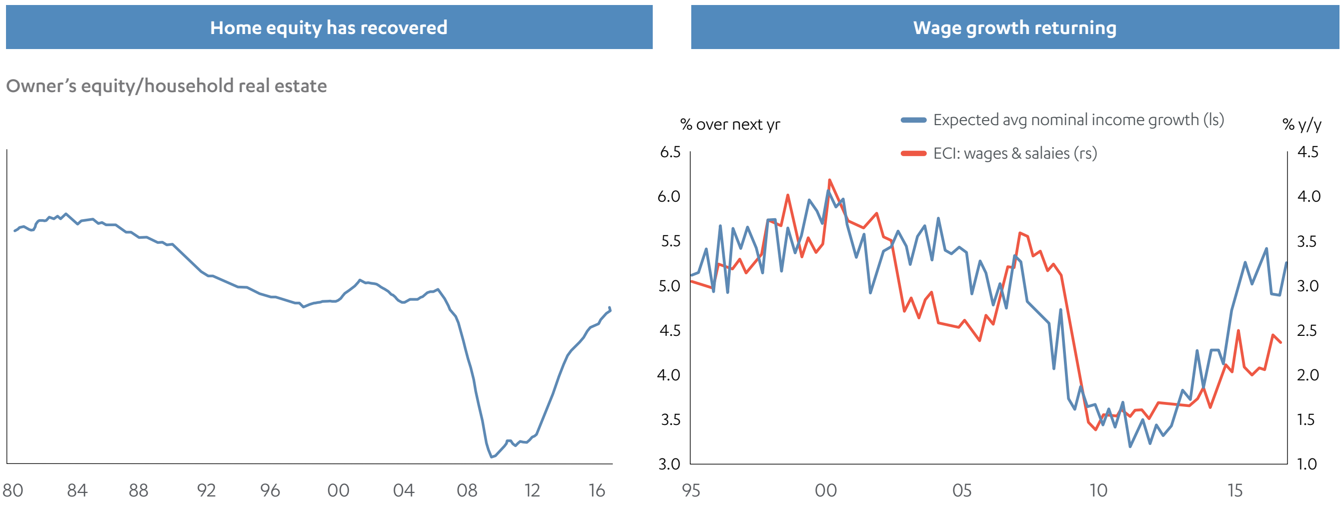
Chart 9: Household confidence supporting growth improvement



Source: FRB, Haver Analytics, DB Global Markets Research

Source: Univ of Mich, BLS, Haver Analytics, DB Global Markets Research

The upshot is that we believe the fall in US bond yields is likely to be a short-lived trend and, as the focus shifts back to reasonable growth and the prospect of rate rises in the US, the forces which crimped the performance of cyclical stocks and fueled bond-sensitives in February will wane and reverse.

Outlook

All in all, Corporate Australia remains in reasonable health, underpinned by strong cost discipline. Management remained focused on capital management in preference to further capex and increased dividends and buy backs should serve to help support the equity market.

Management guidance was conservative on the whole. Australia remains something of a two speed economy – areas of Western Australia, Queensland and South Australia continue to suffer the effects of the mining boom hangover, while the eastern seaboard is in better shape and still feeling the effects of the housing construction boom. Meanwhile, while there are signs of a pickup in global growth, they are relatively nascent and will need to persist to see translation into significant revenue growth. For the most part, in meetings with management, they seemed content to under-promise at this point.

We also remain ever mindful that we are in an environment of significant industrial disruption due to globalization, developments in technology and changes in regulation. The specter of Amazon Prime hovered at the table in many of our meetings with management post-reporting. And it is but one of many developments that companies must be contemplating. The combination of low revenue and industrial disruption serves to sort the wheat from the chaff in terms of management quality. Only those companies with a strong strategy and the ability to execute will ultimately thrive. This is where we deploy our team and company-level insight to greatest effect – finding the companies who are equipped to traverse today's challenging environment.

Nevertheless, the return of positive earnings to the market, backed by a surge in resources and the stabilization in industrials, is encouraging. We are reluctant to rush to conclusions from one data point, however, if sustained, we could be approaching a new phase in the market; one driven by earnings growth rather than the re-rating and thematic trends of recent years. In this vein, it was reassuring that that management in several industries indicated that sequential trends in terms of month-on-month improvement in demand had been evident in the end of 2016 and into 2017.

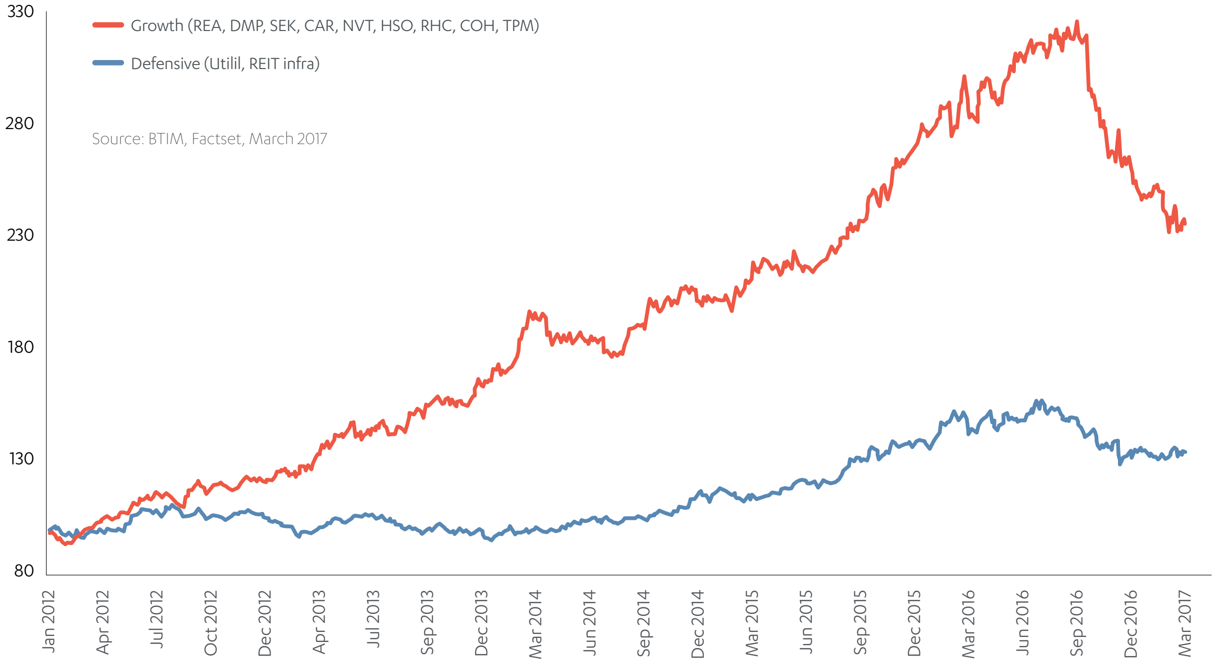
We are in an environment of significant geopolitical volatility. The combination of President Trump's style and controversial policies, ongoing Brexit negotiations and several crucial elections within the EU are likely to prompt bouts of volatility over the next year at least. Nevertheless, it is important to recognize that these episodes are usually short-lived and that we must look beneath them to the underlying environment to get a better guage of prevailing trends in equity markets. In this vein, we are focused on the following five issues:

1) Liquidity: consequences for market rating.
Incremental tightening of US monetary policy means global liquidity is no longer a market tailwind but, in conjunction with ongoing accommodative policies elsewhere in the world, neither is it a headwind. That said, further tightening and the US and China could pose the risk of a de-rating later in the year.

2) Bond yields: impact on rate sensitive and growth stocks.
Sustained improvement in US economic growth and inflationary trends could see continued pressure on bond yields and rate-sensitive stocks such as REITs, infrastructure and utilities. It is also important to recognize that the small cohort of high growth stocks in the Australian market have also benefited from low yields (see Chart 10). They, too, could face headwinds as inflationary pressures build.

3) Chinese economy; impact on resources and housing.
Short term momentum in China remains supportive for resources, with infrastructure picking up where a cooling property market has left off in terms of commodity demand. At the same time, supply and capacity reductions in China also help support prices. However, we remain acutely aware that the momentum and direction of policy in China remains opaque and requires constant vigilance.

Chart 10: Growth stock v bond sensitive relative performance (indexed to Jan 2012)



Source: BTIM, Factset, March 2017

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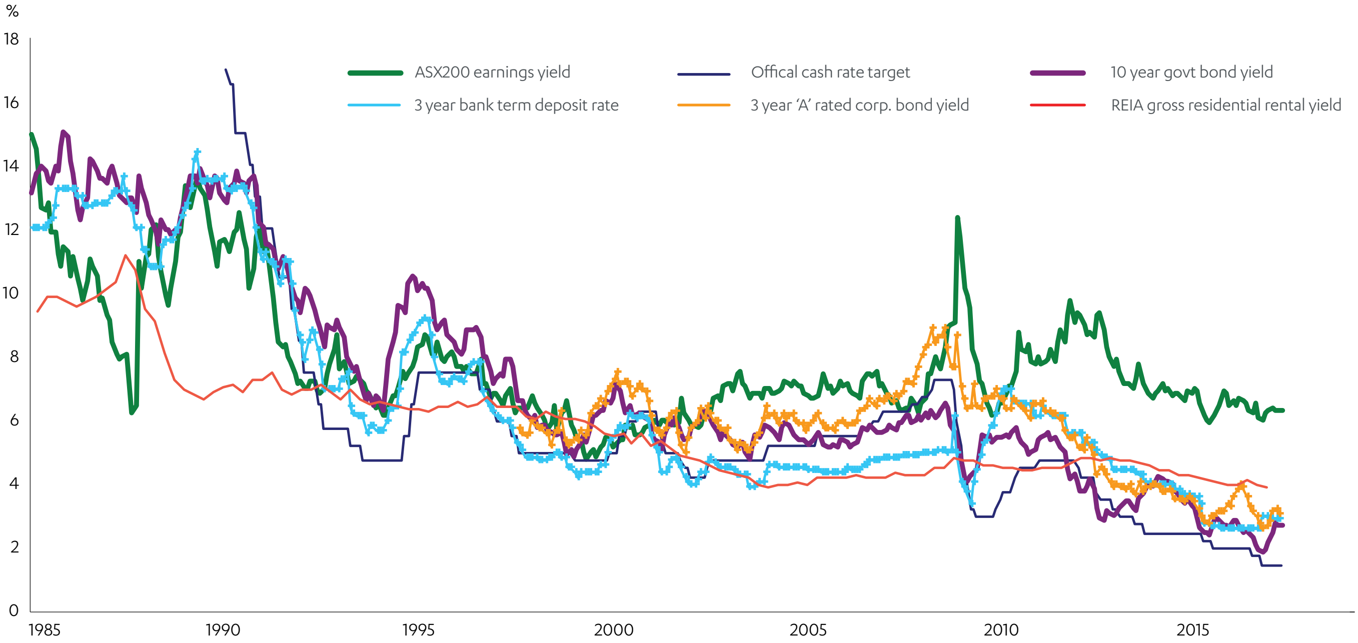
4) Oil: impact on energy and transport.
OPEC and Russia's agreement to limit oil production has helped support the oil price in recent months. At the moment, seeming compliance with the agreement has left the market sanguine on the outlook for the oil price. We see the lack of any acknowledgement that the oil price could move as a key risk in the market.

5) Corporate disruption: impact on multiple sectors.
The disruptive effects on companies and industries of technology, globalization and regulation is an ongoing feature in markets. Recent developments in the supermarket and telecom industries serve as stark examples of how quickly things can change. This demands ongoing scrutiny of the potential threats to an industry or company from new entrants or business models.

Beneath this, the broad environment for equities remains supportive. The market is probably around fair value, given low interest rates, and the uplift in earnings helps support the current rating and gives us comfort that it is sustainable. The second key issue is liquidity, which also remains supportive. Crucially, there remains a buffer between the earnings yield from the equity market and the yield available from most other assets (See Chart 11). This suggests that bonds yields would have to rise significantly from here before the gap is closed and, although we believe that rates are set to increase, they are likely to peak at lower levels than has historically been the case. This should also prove supportive for equities.

Chart 11: Interest rates and yields



Rental yield is adjusted for porperty quality. Source: REIA, CoreLogic RP Data, RBA, IBES, MSCI, S&P, Datastream, Citi Research, March 2016

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