ACTIVE
VIEWPOINT

MARTIN CURRIE
A Legg Mason Company

AUSTRALIAN REPORTING SEASON WRAP

MARCH 2018 FOR WHOLESALE CLIENTS ONLY

REWRITING THE SCRIPT FOR GROWTH

Reece Birtles
Chief Investment Officer,
Martin Currie Australia

After many years of the same old story – cost cutting and slow revenue growth, February 2018's reporting season has offered up some positive news for the Australian market and economy.

> **"In the preceding three months to the February 2018 reporting season, on aggregate, broker analysts had been upgrading their forecasts for Australian equities, reflecting growing confidence in the economy's growth by market players."**

WHAT WE DO EACH REPORTING SEASON

At Martin Currie Australia, we overlay an analytical or statistical view of each reporting season's results on top of the fundamental work carried out by our analysts on individual stocks.

Our framework looks at approximately 160 stocks in the S&P/ASX 200 index. We look at these stocks from four perspectives:

- **Lead-in revision** – the revisions to consensus forecasts in the run up to reporting season
- **Surprise** – how company reported results came in compared with consensus expectations
- **Revisions** – the follow-on revisions by brokers following reporting
- **Price reaction** – the market impact of each result.

We understand the limitations looking at just one stock model at a time can have on seeing larger themes evolve. Our analysis gives us a broader framework to judge the overall pulse of the market from the top down, and apply our insight at the stock and portfolio level.

Key definitions we use

Lead in revision: the average change in broker consensus next 12 month (NTM) forecasts in the 3 months leading in to the reporting season.

Surprise: where there is a >+/-2% difference between company reported results and broker consensus NTM forecasts.

Revisions: the average change in broker consensus NTM forecasts after companies have reported their results .

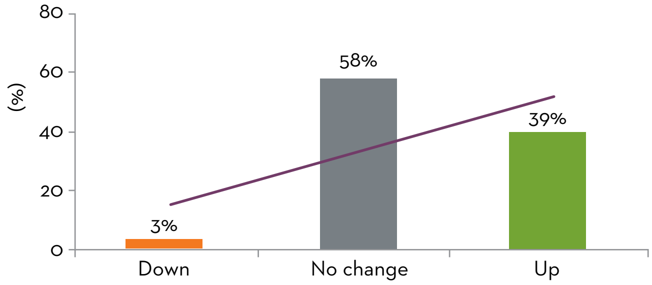
Price reaction: stock price movement within the two days after companies have reported their results.

REPORTING SEASON STARTED WITH HIGH EXPECTATIONS...

In the preceding three months to the February 2018 reporting season, on aggregate, broker analysts had been upgrading their forecasts for Australian equities, reflecting growing confidence in the economy's growth by market players.

Expectations were very high and corporates were also not talking down their guidance ahead of results. The key point from this is that it was clear there wasn't going to be a low base that would be easy to beat.

S&P/ASX 200 EPS lead in revision[1]



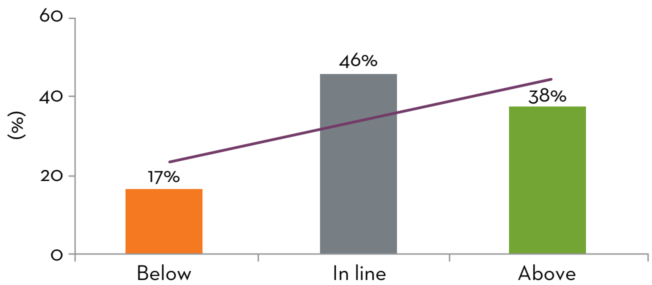
...AND ACTUALS BEAT EXPECTATIONS BY A LONG WAY

Overall, result surprise came in very positive for the Australian market, especially at the top line.

In total, 38% of companies exceeded consensus sales forecasts and another 46% were in line with projections, with only 17% below expectations[1].

This is the best ratio of beats/misses of sales numbers we have seen in a long time, confirming our view of an improving economy and sales growth. It is quite a change to the slow domestic economy and weak sales growth we have been used to, since the end of the mining boom.

S&P/ASX 200 sales surprise[1]



Past performance is not a guide to future returns.

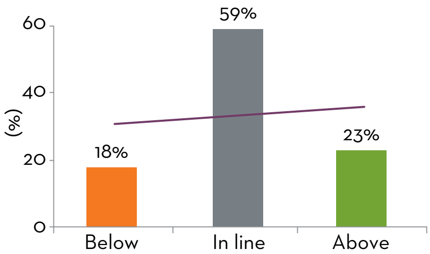
[1]Source: Martin Currie Australia, FactSet; as of 28 February 2018. Calculated using the weighted average of broker consensus forecasts of each holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed.

SALES BEATS CAME FROM ALL SECTORS

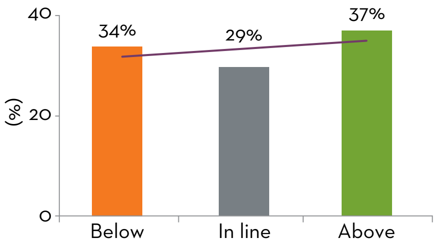
The sales beats were across all sectors, and not just the result of stronger commodity prices boosting the resources sector. We believe we are finally seeing a reversal of the persistently weak trend of the past five years.

What is interesting, however, is the underlying composition of the surprise numbers. While sales beat expectations, the earnings before interest, taxes, depreciation and amortisation (EBITDA), earnings per share (EPS) and dividend per share (DPS) lines were much more subdued.

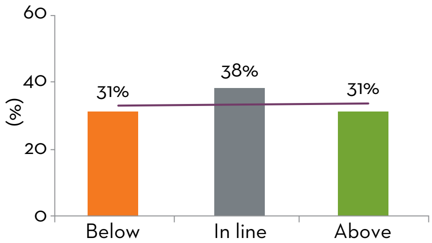
S&P/ASX 200 EBITDA surprise[2]



S&P/ASX 200 EPS surprise[2]



S&P/ASX 200 DPS surprise[2]



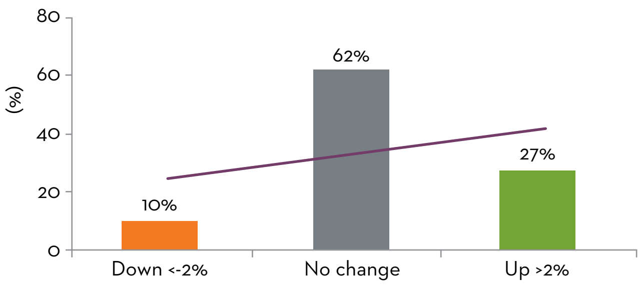
We think this is because companies appear to be spending more to achieve higher sales, resulting in lower profit margins. This contrasts with the past few years where cost-outs were the main driver of profit growth.

BEST REPORTING SEASON FOR A LONG TIME...

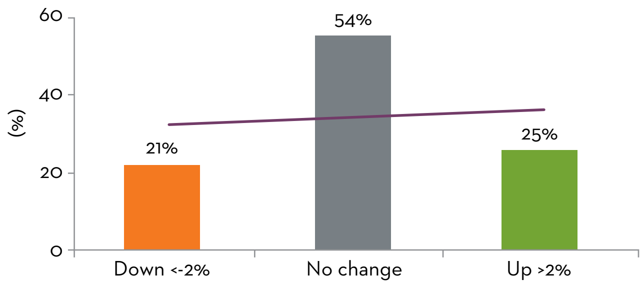
Analysts love to say the current season has been 'more volatile than usual', which helps them feel better about the beats and misses. However, statistically, this was one of the better seasons since the bounce-back following the global financial crisis, with 22% net EPS upgrades vs. downgrades[2].

In aggregate, there were more upgrades to sales forecasts after results, and reasonable upgrades to EBITDA, EPS and DPS forecasts.

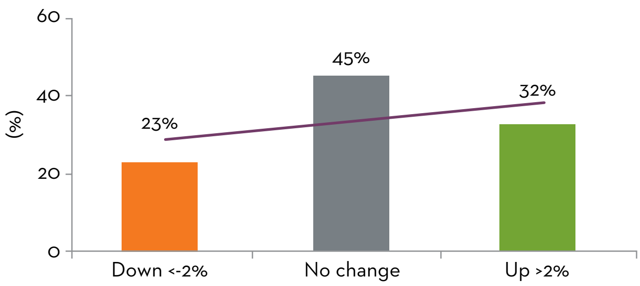
S&P/ASX 200 sales revision[2]



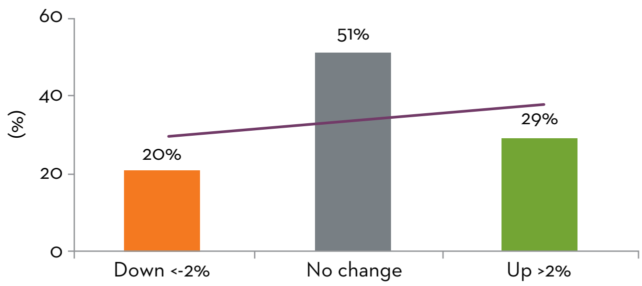
S&P/ASX 200 EBITDA revision[2]



S&P/ASX 200 EPS revision[2]



S&P/ASX 200 DPS revision[2]



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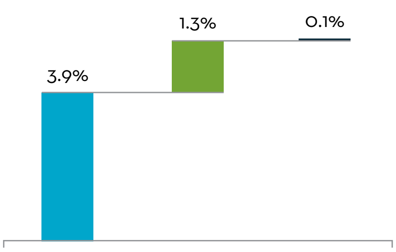
...BUT REVISED EXPECTATIONS WERE UNDER-COOKED

The positive revisions appear to us to have not gone far enough. Given the market sell-off during February, and the ongoing macro uncertainty, we feel manager guidance was subdued, and analysts have not been as bullish when revising their models for future earnings growth.

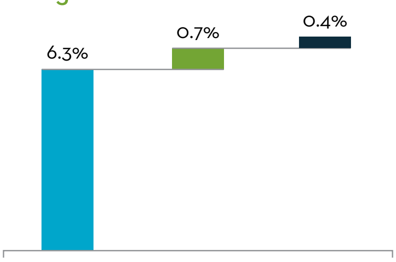
Higher numbers have mostly come from the base effect, in other words that the actuals have come in ahead of the forecasts, lifting the base. Brokers have had to raise their base numbers to match, but haven't changed their forward growth expectations very far.

For example, EPS growth has been revised up by 1.1% over February[3]; but of this, 0.7% has come from the base change as actuals were ahead, only 0.4% has come from upgrades to future expectations. Sales and DPS show a similar story.

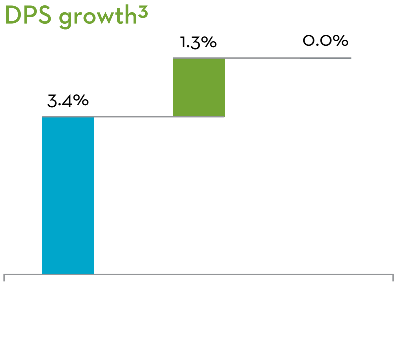
S&P/ASX 200 consensus NTM Sales growth[3]



S&P/ASX 200 consensus NTM EPS growth[3]



S&P/ASX 200 consensus NTM DPS growth[3]

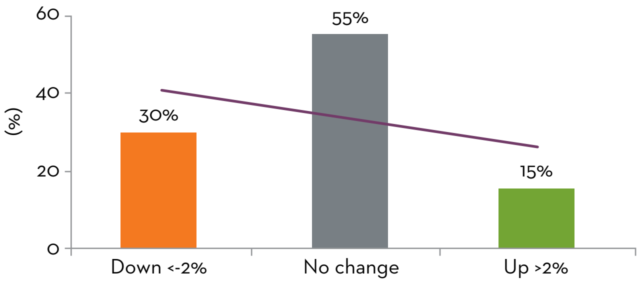


We would expect to see more revisions in the coming months to account for the strength now shown in the overall economy.

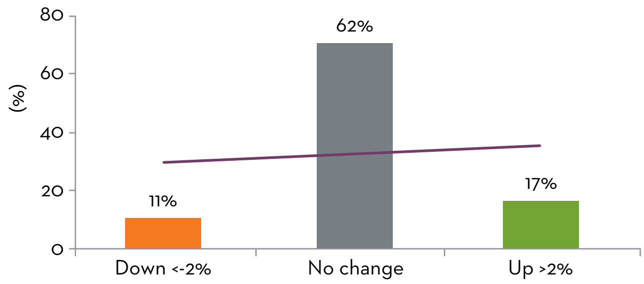
ANIMAL SPIRITS START TO RETURN...

Moving further down the P&L statement, we see that EPS upgrades have not been the result of margin improvements or cost-outs (as they had in previous periods). In fact, we have seen downgrades to lower profit margins, a rise in capex/ investment expectations and misses on free cash flow (FCF) and debt.

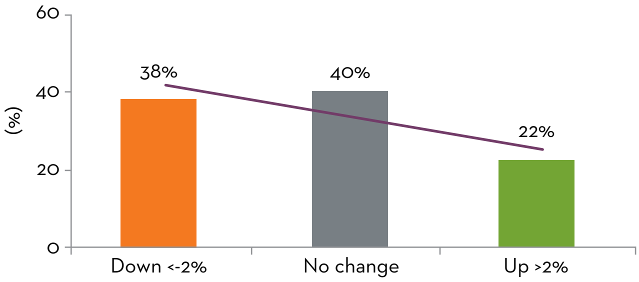
S&P/ASX 200 profit margin revision[3]



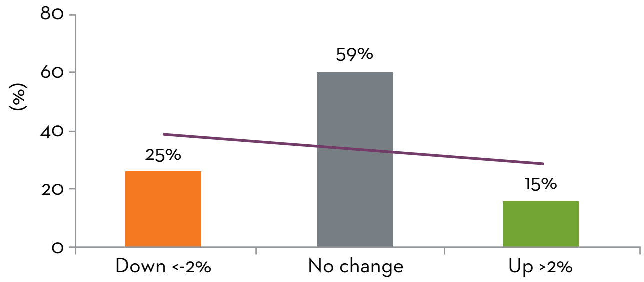
S&P/ASX 200 capex revision[3]



S&P/ASX 200 FCF revision[3]



S&P/ASX 200 debt revision[3]



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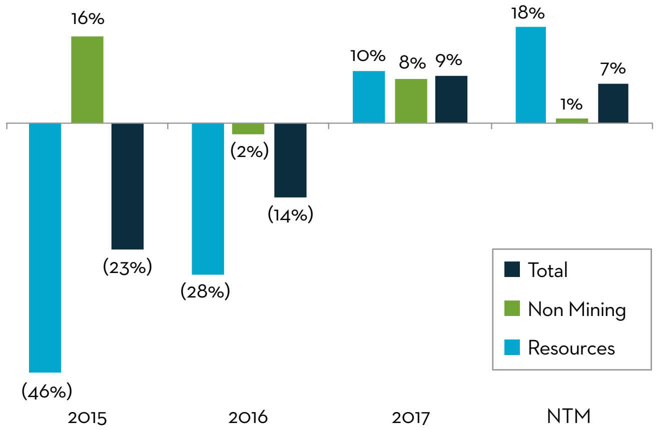
[3]Source: Martin Currie Australia, FactSet; as of 28 February 2018. Calculated using the weighted average of broker consensus forecasts of each holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed.

This is not a bad thing. Instead, it is a sign global growth and inflation finally looks to be making its way into corporate Australia.

Strong purchasing managers index (PMI) numbers, and an increase in expected capex of almost 10% in 2017 (up from a 14% decrease in 2016)[4], point to the return of corporate 'animal spirits'.

> It is pleasing to see both resources and industrial companies have started to ramp up investment again after many years of cutting costs.

S&P/ASX 200 consensus NTM capex[4]

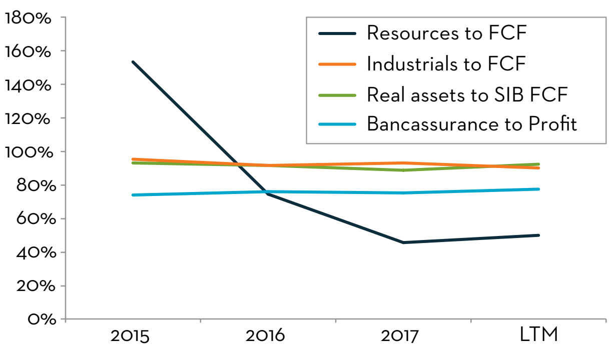


It is pleasing to see both resources and industrial companies have started to ramp up investment again after many years of cutting costs.

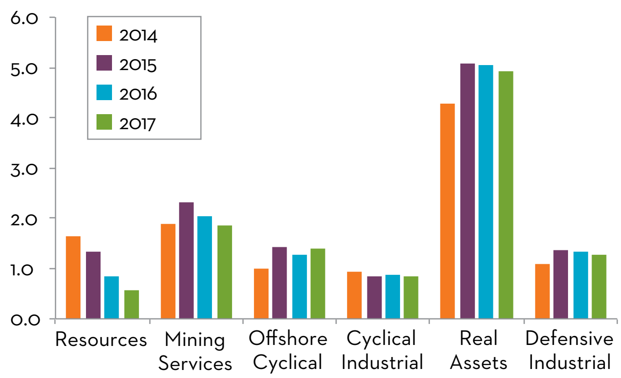
...AND CASH TO SPLASH FOR DIVIDENDS...

In addition, higher capex hasn't put a dent in dividend payments, which have remained steady, while debt is also falling.

S&P/ASX 200 consensus dividend payouts[4]



S&P/ASX 200 consensus dividend payouts[4]



Past performance is not a guide to future returns.

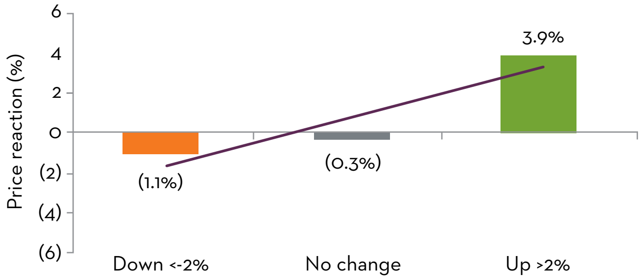
[4]Source: Martin Currie Australia, FactSet; as of 28 February 2018. Based on MCA internal sector classifications. Calculated using the weighted average of broker consensus forecasts of each holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed.

...BUT PRICE REACTION INDICATES DEFENSIVE MARKET TONE

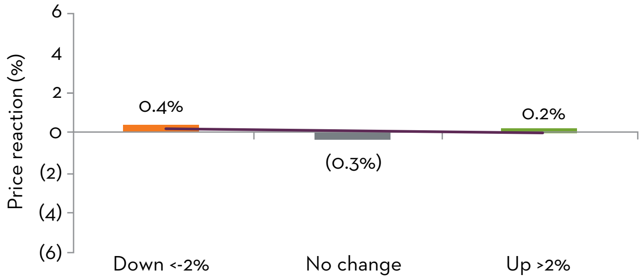
One of the trends we look at is the price reaction of stocks in the two days after companies have reported. The average stock that beat EPS has had a 3% outperformance, while those that missed, underperformed by 4%[5].

Tradition tells us that the market always cares about EPS, so this is to be expected. What's interesting though is how the market treated the composition of EPS revisions. Regarding stocks with revisions to sales, capex and FCF revisions, it was fairly neutral. What it really cared about was revisions for margins.

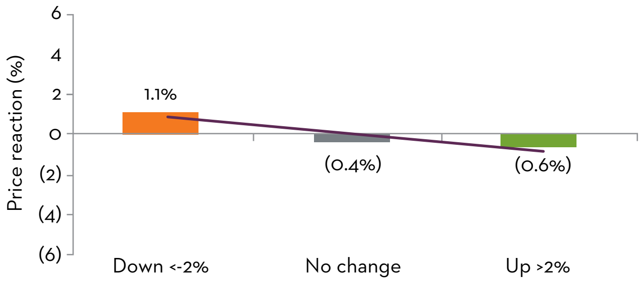
S&P/ASX 200 profit margin revision[5]



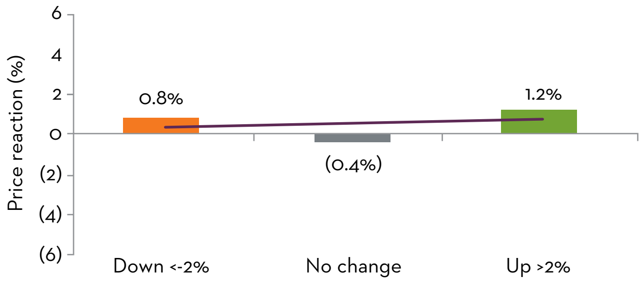
S&P/ASX 200 capex revision[5]



S&P/ASX 200 FCF revision[5]



S&P/ASX 200 sales revision[5]



This tells us that the market is tonally 'defensive'. It still prefers cost-out stories to sales growth stories, even through increased investment should result in better bottom line growth in the future.

This is a good reason as to why fundamental research really works best. In the short term, the market focuses only on the actual EPS numbers and not how they are achieved. By undertaking in-depth fundamental research, we can get an advantage by investing in companies with good FCF compared to their EPS ratios.

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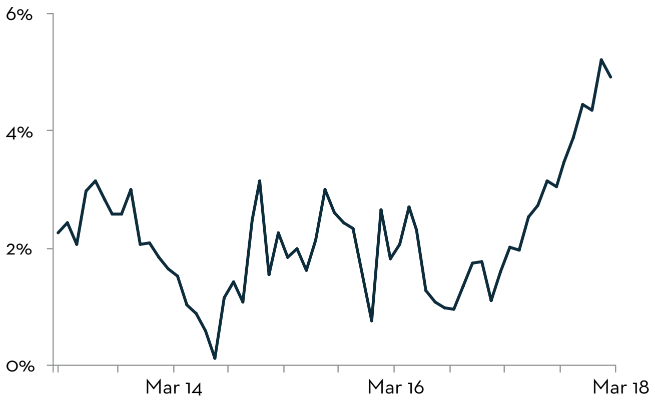
[5]Source: Martin Currie Australia, FactSet; as of 28 February 2018. Calculated using the weighted average of broker consensus forecasts of each holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed.

LOWER PROFIT MARGINS MEAN MORE SUSTAINABLE GROWTH

Needless to say, growth, based on greater investment and lower margins, is a much more sustainable position for the economy to be in than the very low revenue growth and cost-out stories of the past few years.

We've been waiting for signs that Australia's nominal GDP growth is recovering, and for that growth to spread from resources and property to the broader domestic economy. In this reporting season, we are starting to see this happen.

S&P/ASX 200 Industrials consensus NTM revenue growth[6]



Australian corporates have continued to generate healthy profit growth utilising the levers they can control in a low nominal revenue growth environment, and we are beginning to see more signs of the increased investment which is required to lift growth rates.

> "We've been waiting for signs that Australia's nominal GDP growth is recovering, and for that growth to spread from resources and property to the broader domestic economy. In this reporting season, we are starting to see this happen."

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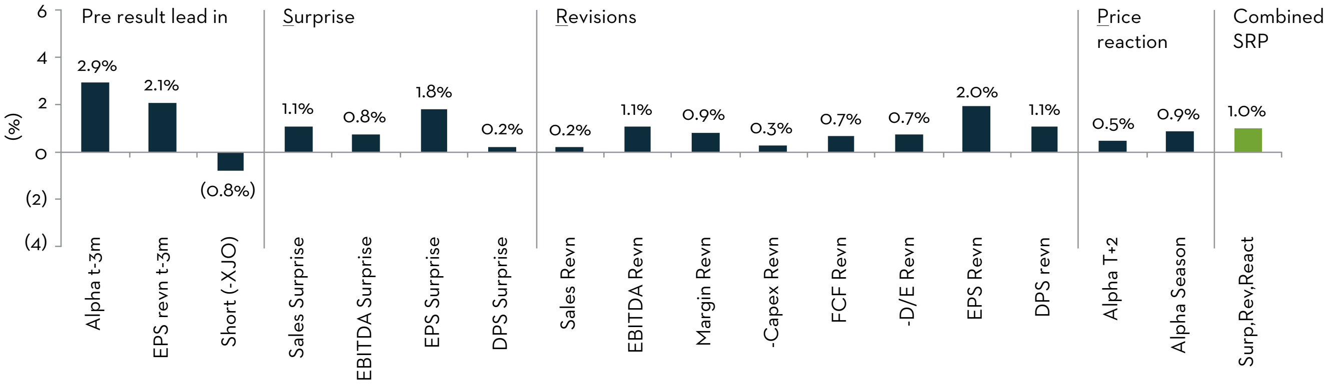
[6]Source: Martin Currie Australia, Factset; as of 28 February 2018. Calculated using the weighted average of broker consensus forecasts of each holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed.

VALUE EQUITY STRATEGY DID WELL

To impartially assess our performance over the full reporting season, we look at a combination of Surprise, Revisions and Price Reaction (SRP) to score the market and our portfolio's performance.

Our Value Equity strategy showed a stronger relative SRP of 1% versus the S&P/ASX 200[7].

Value Scorecard (relative to S&P/ASX 200)[7]

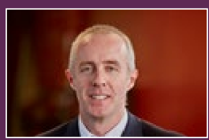


While reporting season always throws up positive and negative surprises, our portfolios overall were on the positive side of fundamental results, with positive results across the board, validating the strong alpha of 0.9% over the season[7].

Some of the best results came from portfolio holdings in Nine Entertainment, **Seven Group, IAG, LendLease, Resmed, Fairfax** and **Iluka,** while **AGL** and **G8 Education** disappointed[7].

INSIGHT GAINED THROUGH COMPANY INTERACTION

Over the four-week reporting period our team conducted around 100 meetings with company management teams following the release of results. These meetings enabled us to gain a better understanding of the issues and strategies of each business that we use to refine our views on each investment case. Here are some of the most interesting insights we gathered over the period[7]:



Patrick Potts
Research Analyst

Real estate name **Domain** is at an interesting point, with its star CEO Antony Catalano resigning at Christmas. The business was previously all about him, but our recent meeting with top management revealed a much deeper organisation with data at its heart. We see strong potential for data mining, and controlling leads for sales process going forward.

We also learned more about **Fairfax Media's** joint venture with **Google**, which is set to start in March. The two companies have inked a revenue-sharing deal, which we see as a game changer, enabling monetisation of content in the digital space for Fairfax, and tackling the issue of fake news, which is so important for Google's authenticity. There is also the potential for further cost-outs on collaboration with News Corp on printing and distribution.

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[7]Source: Martin Currie Australia, Factset; as of 28 February 2018. Data shown for a representative Value Equity account Calculated using the weighted average of broker consensus forecasts of each holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed.

Andrew Chambers
Portfolio Manager – Real Income

Despite a gas shortage and the lag in benefiting from the rising wholesale electricity prices, we believe that **AGL Energy** is still well positioned for growth. Management commented on retail competition, but sees the discounting threat diminishing. It will be the second-tier energy retailers earning 2-3% margins that are more vulnerable to further discounting.

Matt Davison
Senior Research Analyst

We are confident **AMP** management can turnaround its advice business to offset a decline in the legacy asset management business. It has also embraced technology, and its robo advice goals-based offering looks very promising.

Management meetings with financial services company **IOOF** have highlighted further how its unique low-cost platform & advice business model is attracting independent financial advisers (IFAs) away from vertically integrated businesses. IOOF offers investors a high cashflow business and ongoing organic and acquisition driven growth.

Jim Power
Research Analyst

On the **JB Hi-Fi** results call there was only one mention of Amazon in one and half hours, but at our discussions with management we didn't talk about anything else.

Management are preparing the business to be 100% competitive against Amazon and are prepared to burn margins to do so. The company won't be beaten on price in order to protect its brand reputation with customers.

In order to compete against the likes of Amazon, companies need high productivity and a low cost of doing business, unless it is a specialty retailer that is vertically integrated. Looking at retailers using a matrix of sales productivity versus the cost of doing business, JB Hi-Fi is among the best in the world. It will be the smaller, less productive retailers that will suffer.

Similarly, for **Woolworths**, there is a saying that should ring true: 'when the elephants are fighting, the ants die first'. It will be the small independents that will suffer in any price wars going forward, potentially with Amazon.

But the interesting point from discussions with Woolworths' management is the plans for big data. It is now one of the biggest data owners in the country, with transaction data on baskets, line items and economic activity allowing the company to track customer behaviour and target individual promotions. Just 18 months ago it did not employ any software engineers employed, but now has a big team.

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