ACTIVE
VIEWPOINT

# AUSTRALIAN REPORTING SEASON WRAP

**MARCH 2019** FOR WHOLESALE CLIENTS ONLY

# CLOUDED BY POLITICAL, ECONOMIC AND CREDIT UNCERTAINTY

**Reece Birtles**
Chief Investment Officer,
Martin Currie Australia

The Australian reporting seasons (in February and August) are important periods for markets, with much more fundamental company information available to investors than at other times in the year.

This season, however, while company fundamentals are largely intact, profit results have been clouded by negative sentiment coming from politics, financial conditions and house prices.

In the following paper, our team of Australian investment specialists, led by Reece Birtles, Martin Currie Australia's Chief Investment Officer, provide context to the recent company reporting season and economic environment, from both a fundamental and analytical perspective, and discuss the implications for our portfolios.

> Our framework allows us to judge the overall pulse of the market from the top down, and assess the themes across the market that would be ‘hard to see’ when looking at each company result in isolation.

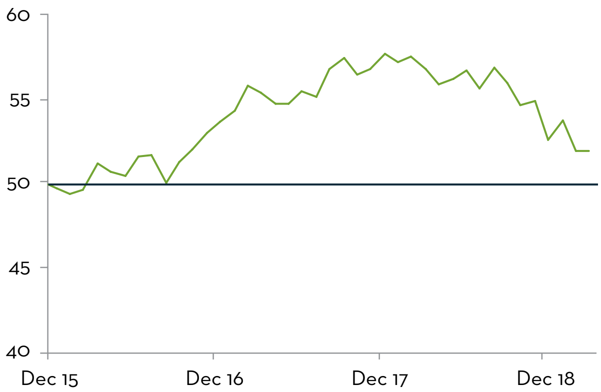
## KEY POINTS

- Despite the lower expectations for results in the lead in, February's results represented a relatively balanced delivery, and were especially good for sales and franked income outcomes.
- While company fundamentals are largely intact, this reporting season, profit results have been clouded by the negative sentiment on politics, financial conditions and house prices. Increasing investment requirements have also reduced both company and consensus growth outlooks.
- Issues companies and consumers are facing include the tight financial conditions; house prices; and the impact on consumer confidence and business formation. The large infrastructure pipeline, which should help to counter the housing downturn, is taking longer than expected to deliver. However, Australia's government budget surplus position provides it with good monetary and fiscal options to boost the economy leading into the election.
- With healing of global economic conditions on its way, the economic cycle will probably be delayed or prolonged. This will be positive for both company fundamentals and markets, and we believe it is hard to see another sell off like last year.
- Market disconnects on fundamentals such as these can offer significant opportunities for research-driven stock picking.

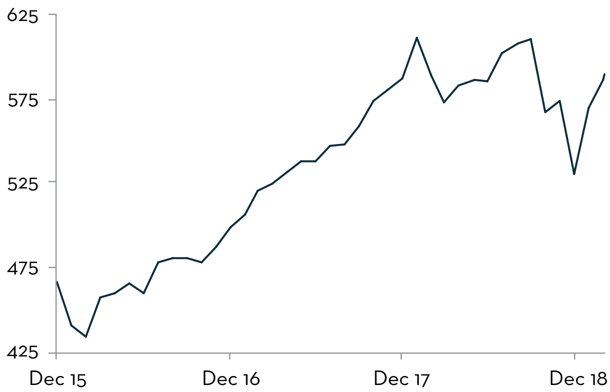
## BACKGROUND OF WORSENING ENVIROMENT

Ahead of the February 2019 season, markets had seen a big sell off in late 2018. Meanwhile global economic data, such as world PMI[1], had started to fall from around September on the back of the US Federal Reserve (Fed) rate rises, the ongoing US/China trade war, liquidity crunches in credit and emerging markets (EM), and the strong US dollar. These weighed on markets globally. However, at the time, the US data remained strong.

World economic growth (PMI)




World Markets Price Index (MSCI)




At Martin Currie Australia, over the course of February's reporting season, our analysts conducted 150-160 meetings with company management.

On top of our fundamental analysis and company engagement on individual stocks, we have a framework to overlay an analytical top-down view of the reporting season's results for the stocks in the S&P/ASX 200 index.

This aggregated review of consensus **lead-in revisions**, **surprise** (hits vs. misses), **follow-on revisions**, and the market's **price reaction**[2] to the results, allows us to judge the overall pulse of the market from the top down, and assess the themes across the market that would be 'hard to see' when looking at each company result in isolation. We can then apply our insight at the stock and portfolio level.

**Past performance is not a guide to future returns.**

Source: Martin Currie Australia, Factset; as at 28 February 2019.

[1]PMI is derived from monthly surveys of private sector companies, provides a picture of business conditions. MCA combine regional PMIs based on GDP weights.

[2]See full definitions at end of document.

## LOWERED EXPECTATIONS IN LEAD-IN

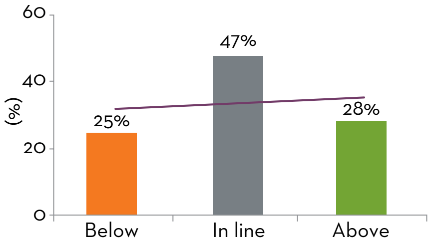
While markets have recovered somewhat post December 2018, US economic data now looks worse than it had been when markets were falling last year.

Because of this uncertainty, revisions to Australian company consensus earnings-per-share (EPS) next-twelve-month (NTM) forecasts by broker analysts had been particularly weak in the lead in to results. This is despite a lack of profit warnings from the companies themselves.

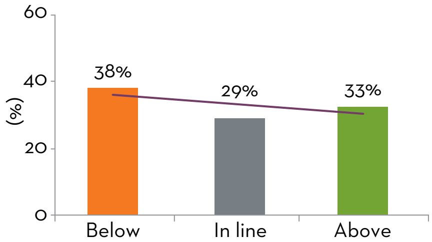
## MORE MISSES THAN BEATS ON EARNINGS, BUT REVENUE A SURPRISE

So how were results versus market expectations? Our definition of a beat or miss is what we call 'surprise'. For us, this is a difference of greater than plus or minus 2% between a company's reported results and the consensus forecasts across a number of important line items in the profit and loss statement.

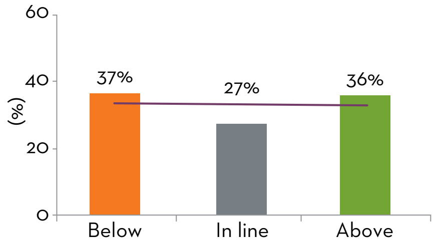
**Sales surprise**




**EPS surprise**




**DPS surprise**




On aggregate, sales or revenue results surprised on the upside, implying that consumer spending may not have necessarily fallen as far as feared in Australia.

There have been more misses than hits for the EPS line, but this was still relatively good versus typical patterns.

## DIVIDENDS DRIVEN BY POLITICS

The dividends per share (DPS) line finished with a reasonably flat skew. This is an interesting theme to point out given the lower EPS numbers. The driver of this appears to be the expected result of the imminent Federal election rather than earnings or cashflow, and what that means for the rules for franked dividends going forward.

**Will Baylis**
Portfolio Manager

The potential for a new Labor Government following elections this year brings the possibility of changes to rules on cash refunds for franking credits to retirees who manage their own superannuation funds. I wrote to every major company held in our portfolios which had a large franking balance, reasonable capital position and strong cashflows. These companies included **Woolworths, Wesfarmers, Woodside Petroleum, Adelaide Brighton Cement, JB Hi-FI, ASX** and **Caltex**.

We asked boards to consider capital-management strategies that could release surplus franking credits to investors in case the rules are changed in June.

We received a positive response from each company, and with the announced special dividends and companies bumping up their payout ratios across the market, company boards are evidently taking the possibility of government change very seriously and heeding our request to ensure franking credit economic value doesn't get lost to shareholders.

We observed a significant positive surprise in dividends for our Income portfolios relative to the broader market. We also note that the future value of franking credits remains, with most investors still in the 15% tax rate cohort regarding their superannuation savings. Companies we have engaged with have, in many cases, said they remain committed to distributing surplus franking credits in the future.

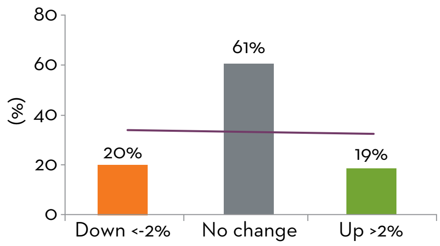


Source: Martin Currie Australia, Factset; as of 28 February 2019. Data for the S&P/ASX 200 Index. Calculated using the weighted average of broker consensus forecasts of each holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed.

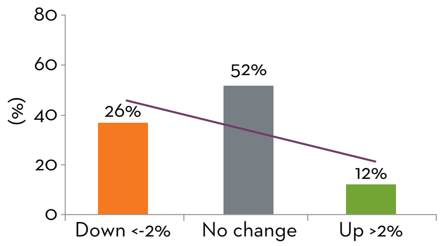
## REVISIONS DOWN ACROSS THE BOARD

Consensus revisions had a negative skew, signalling the market has a much less positive view of the future than during the lead-in.

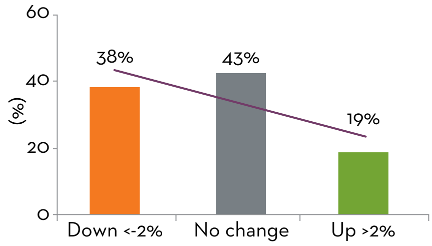
### Sales revision




### EPS revision




### DPS revision




The sales line was relatively flat, but EPS and DPS had quite a pronounced negative skew. The modest DPS revisions can be explained by companies lifting dividends to release surplus franking credits in the last half, meaning forecast dividends are now off a higher base.

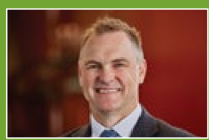
Ironically, growth in future dividends is coming from those resource companies that were cutting a few years ago, but are now the ones paying out. However, this means they are spending almost nothing on capital expenditure (capex), and this lack of spend is causing their growth rates to decelerate.

We do not believe these EPS downgrades are due to cost problems, but instead are a result of companies increasing investment in technology, automation, compliance, or simply investing to grow. In some sectors, this will lead to lower free cash flow for dividend payments, but will also allow for new revenue opportunities.

**Matthew Davison**
Senior Research Analyst

Banks, super providers and other financial services companies are being required to invest heavily in compliance. While there are different attitudes as to whether this investment spend is permanent or temporary, automation is set to replace more jobs and reduce compliance spend in areas of high regulatory focus, benefiting large players such as **Suncorp, IOOF, Commonwealth Bank**. There is, however, debate as to whether or not the banks can actually attain these efficiency gains.

Technology leadership will enable new revenue streams, benefiting companies such as **ASX** which has invested heavily in blockchain technology to cut out the custody and registry middle-men.



**Michael Slack**
Head of Research

We are seeing a cautious approach to investment from the major miners. However, oil companies may be the exception, with all three majors planning to invest heavily in liquefied natural gas (LNG) over the next five years.

On the cost side though, labour inflation does seem to be an impact, with pockets of skilled labour being bid up. Blue collar workers, on the other hand, are getting no better than CPI increases.

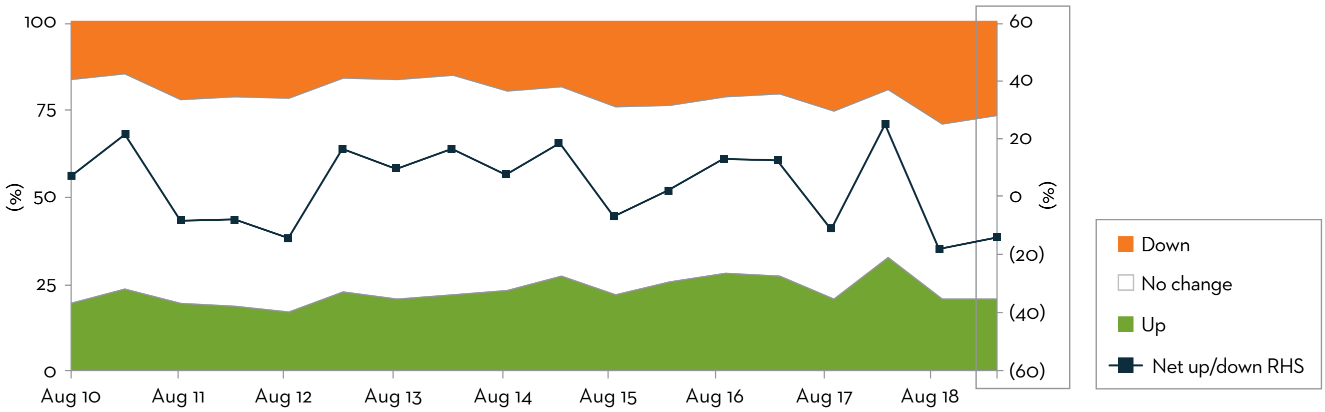
**Past performance is not a guide to future returns. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.**

Source: Martin Currie Australia, Factset; as of 28 February 2019. Data for the S&P/ASX 200 Index. 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.

## POOR REVISIONS STEM FROM THE ECONOMIC AND POLITICAL ENVIROMENT

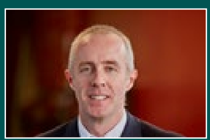
Looking at the trend of revisions over the last few years, the most recent result is marginally better than August 2018. That said, August was the worst for negative EPS revisions in ten years.[3]

**History of earnings revisions during reporting month*** **February 2019 reporting season**



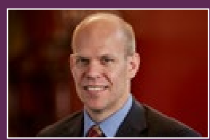

This season, it's a lack of upgrades that is driving this trend, rather than particularly bad downgrades. Also, despite results which are relatively ok, we are seeing a real lack of positive guidance from companies.

This lack of positive attitude ties back to the political and economic environment. With all the insecurity in the lead up to the next election, companies are very wary of sticking their necks out, and instead only issuing very generalised guidance statements.



**Patrick Potts**
Research Analyst

A good example of a company being wary in the current environment, despite good results, is **Seven Group**, a diversified operating and investment group in the media, mining and construction industries. Seven Group is running way ahead of earnings guidance for the year, but company management has declined to upgrade its guidance, apparently preferring to wait and see instead.



**Andrew Chambers**
Portfolio Manager – Real Assets

Politics has also had an impact on company guidance. Energy firm **AGL** beat market expectations by a large margin in the first half, but didn't upgrade for the full year because of the political pressure on excess earnings – it would be negative for the company in terms of public perception if it was seen to be making too much money.

**Past performance is not a guide to future returns. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.**

Source: Martin Currie Australia, Factset; as of 28 February 2019. Data for the S&P/ASX 200 Index. 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.

[3]Up: upwards revisions to broker consensus NTM EPS forecasts after company reported results >2%; Down: downward revisions to NTM EPS >-2%.

**Ashton Reid**
Portfolio Manager – Real Assets

Tight financial conditions are also impacting businesses, both directly and indirectly.

Take **Stockland** for example, for a flow-on effect from credit tightening. Stockland owns and operates a portfolio of shopping malls in more regional locations. These centres rely on leasing to new franchises run by small businesses. These small-business owners often borrow against their houses to raise funds. However, with mortgage credit tightening, they are finding it hard to form businesses, and as a result, Stockland is finding it difficult to fill its shopping centres with quality tenants.

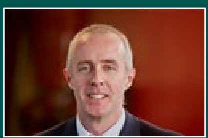
**Chris Schade**
Research Analyst

Waste-management company **Bingo** had a big downgrade to FY19 EPS, due to weaker-than-expected building construction, causing operators to reduce prices in order to keep their trucks and other assets utilised.

Looking forward, with fewer house demolitions required to make way for new apartment buildings, there will be less demand for Bingo's skips and associated resource-recovery assets from the key residential-construction segment.

## UNINTENDED IMPACTS ON COMPETITION

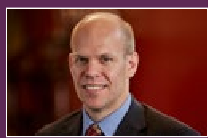
An adverse consequence of some of the government policies coming through is that Australia's oligopolies are being further entrenched rather than being broken down.



**Patrick Potts**
Research Analyst

One example of an unexpected impact of government policy is the Productivity Commission's review of private health insurance. Labor's proposed 2% cap on premiums would be expected to have an impact on the big players, but instead it is likely it will lead to resilience of companies with strong market positioning, benefiting **Medibank Private** over mutual health organisations, because its scale gives it the ability to reduce costs, or invest in technology or lower-cost home care.

Aged care will be the next sector to be impacted by politics, with the new Royal Commission into Aged Care Quality and Safety beginning. We are currently seeing low occupancy rates in listed providers, but we believe the royal commission may improve the funding model for the large players, by highlighting that that the government needs to spend more in this area.



**Andrew Chambers**
Portfolio Manager – Real Assets

Another unintended government consequence is in energy retailing, and the policy for the introduction of default offer price caps. The big players such as **AGL Energy** or **Origin Energy** have vertical integration and the scale to help absorb changes, however many of the tier-2 and tier-3 resellers don't have vertical integration and their discounting model may come under pressure from lower default offer pricing.

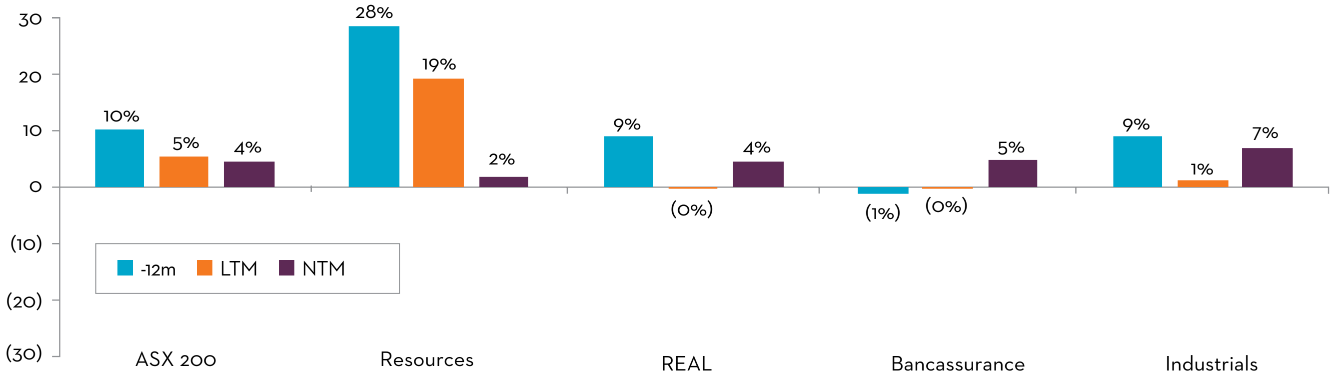
**Past performance is not a guide to future returns. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.**

Source: Martin Currie Australia, Factset; as of 28 February 2019. Data for the S&P/ASX 200 Index. 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.

## INFRASTRUCTURE PIPELINE TAKING LONGER TO DELIVER

Australia has had massive divergence on growth expectations between resources and industrials over last few years. However, as the chart below shows[4], the growth expectations are now more balanced (and lower) across all sectors.

**Sector profit growth remarkably consistent**



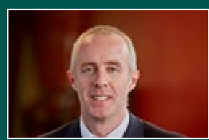

While we had always expected that housing prices in capital cities would need to fall to more reasonable levels at some point, we had also expected that increased infrastructure demand would pick up the slack in the industrials space and balance out the impact on the economy.

It is clear from company results and commentary that we are not yet getting that pick up, but we believe we should see more future growth as the pipeline remains very large and there are no cancellations of projects.

**Jim Power**
Research analyst

There is a huge amount of new infrastructure activity starting, such as the Metro and Westgate tunnels in Melbourne, but these are still at early stages with clearing and digging stages taking time.

While construction-materials companies, such as **Boral** and **Adelaide Brighton Cement**, will ultimately benefit from the building of new roads with their more expensive aggregates, they are impacted in the short term, as the excess amount of cheap fill flowing into the market from current digging activity competes with materials from their quarries.



**Patrick Potts**
Research Analyst

New tunnels are great for **Seven Group's** Coates Hire business, as there is a huge need for the safety equipment the company hires out.

However, this part of the construction hasn't started yet, and Coates has already put in the capacity in anticipation. As a result, it is made to compete on price in the short term.

**Past performance is not a guide to future returns. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.**

Source: Martin Currie Australia, Factset; as of 28 February 2019. Data for the S&P/ASX 200 Index. 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.

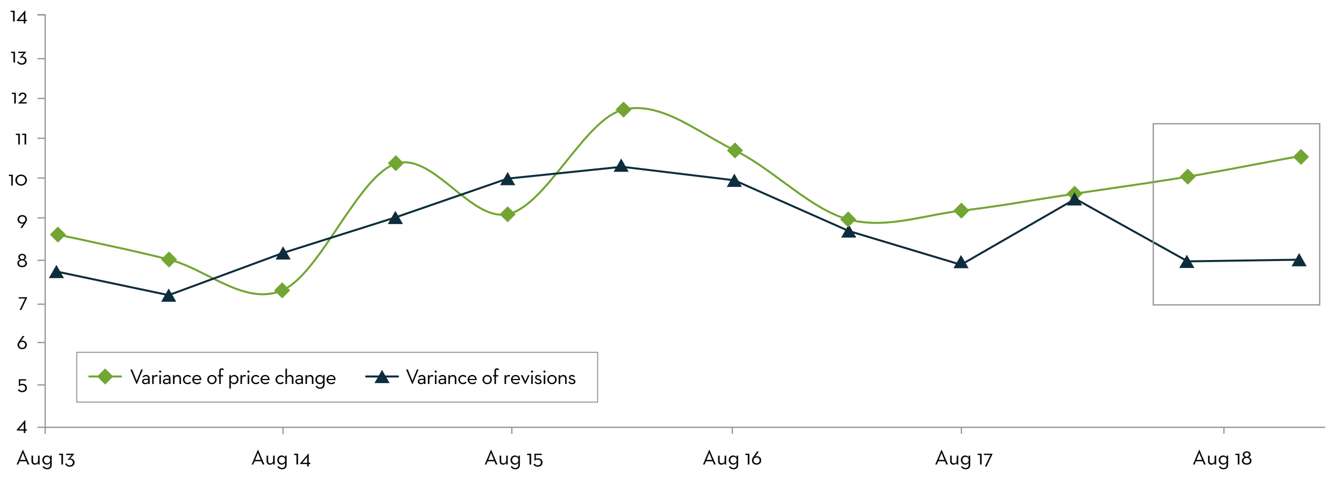
4 -12m: 12 months actual through 28 February 2018; LTM: last 12 months actual through 28 February 2019; NTM: next 12 month forecasts.

## IS EVERY REPORTING SEASON TOUGHER?

Every season it's common to hear investors say it's getting tougher to know how the market will react to the new fundamental information available. One of the important trends we look at for this is the price reaction of stocks in the two days after companies have reported.

We can track the 'difficulty' by looking at the market's cross-sectional variance: that is, the standard deviation of all changes in EPS revisions/price across all stocks in the market.

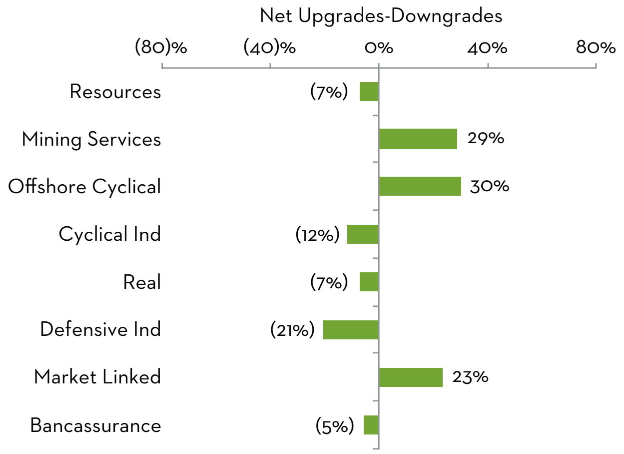
### Cross section variance




This season, the variance in EPS revisions was fairly modest – almost as low as it gets – but the variance in the price reaction was, just as it was last season, quite high. And, this high number also masks the even higher intra-day moves.

Because of the increasing prevalence of quant-based high-speed trading for passive or smart ETFs, we think that we are going to see less underreactions by the market to any new fundamental info, but instead will see more overreactions soon after any information is released.

### Price reaction




## WHO DID WELL? CYCLICALS OUTPERFORM DEFENSIVES

Interestingly in the industrial space, it was the more cyclical sectors (offshore cyclicals, mining services) that performed better than the defensives (supermarkets, healthcare).

Within industrials, consumer discretionary fared better than staples, where price deflation was larger than expected for the supermarkets. Despite media reports about low foot traffic, there was no train wreck in sales figures reported by the retailers (as had been widely expected). In fact, aggregate growth rates for retailers are positive for the year.

**Past performance is not a guide to future returns. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.**

Source: Martin Currie Australia, Factset; as of 28 February 2019. Data for the S&P/ASX 200 Index. 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.

**Jim Power**
Research analyst

Weather has had a major impact on **Coles** sales, with 71 stores out of action in December alone due to flooding. Sales were also disappointing over the spring racing carnival, with a marked decrease in alcohol sales due to the rain.

Woolworths has signalled that it should be able to raise earnings before interest and taxes (EBIT) margins as it sees an end to price deflation. This had been caused by tough competition with Coles, as well as a three-year price-cutting program designed to bring prices in line with its rival, and build out 'premium' private-label offerings to compete with Aldi. This program is now complete, with the introduction of a new private-label healthcare range.

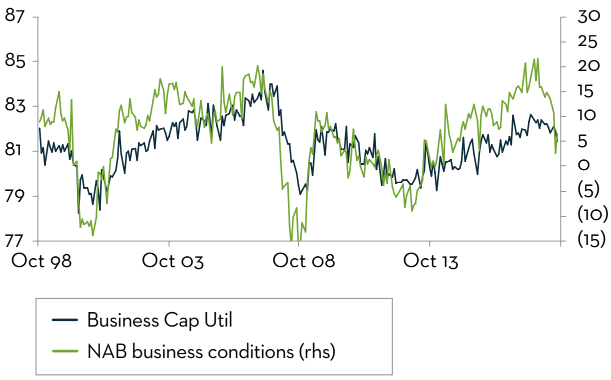
However, companies with high employee costs, such as the supermarkets, are vulnerable to a Labor government due to rises in enterprise bargaining agreements (EBA), and companies have already seen stronger bargaining power from employees. Coles has already completed its EBAs, but this is still to come for Woolworths. The end of price deflation should see a stronger ability to cover these costs.

## ECONOMIC IMPROVEMENT ON THE HORIZON

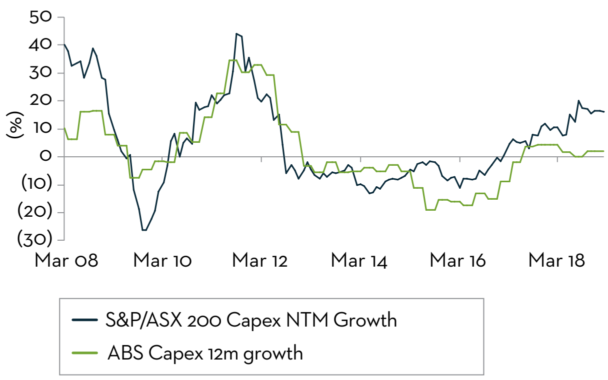
While we are seeing lots of uncertainty in the company results, the good news is that the issues that caused PMIs to fall last year are coming to some sort of conclusion: the US/China trade war is almost 'fixed', and the tight financial conditions, strong US dollar and EM weakness caused by the Fed raising rates last year should now ease, due to the new dovish tone.

The current situation for Australian businesses is positive – it just feels like it is getting worse. Employment growth is strong, capex is rising, wages are growing, and consumer sentiment is still ok, because its driven more by actual household incomes and not house prices. Meanwhile, the Reserve Bank of Australia's now neutral stance relaxes financial conditions.

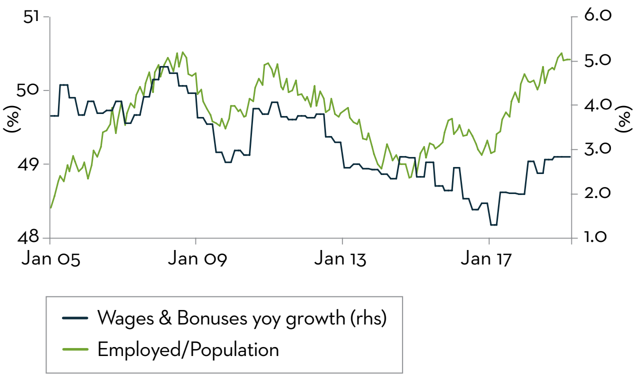
### Capacity utilisation and business conditions



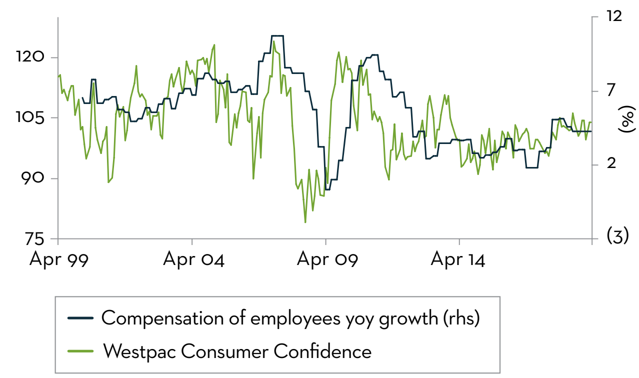

### Capital expenditure




### Employment and wages




### Confidence and compensation




**Past performance is not a guide to future returns. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.**

Source: Martin Currie Australia, Factset; as of 28 February 2019. Data for the S&P/ASX 200 Index. 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.

The government's budget balance going to surplus provides greater flexibility on monetary and fiscal options, tax receipts are up, and the tax take per household is at record levels. We believe the election will bring tax cuts and greater infrastructure spend, no matter who wins.

As such, with this healing of economic conditions on its way, the economic cycle will probably be delayed or prolonged. This will be positive for both company fundamentals and markets, and we think it is hard to see another sell off like last year.

## OUR STEADFAST FOCUS ON THE FUNDAMENTALS

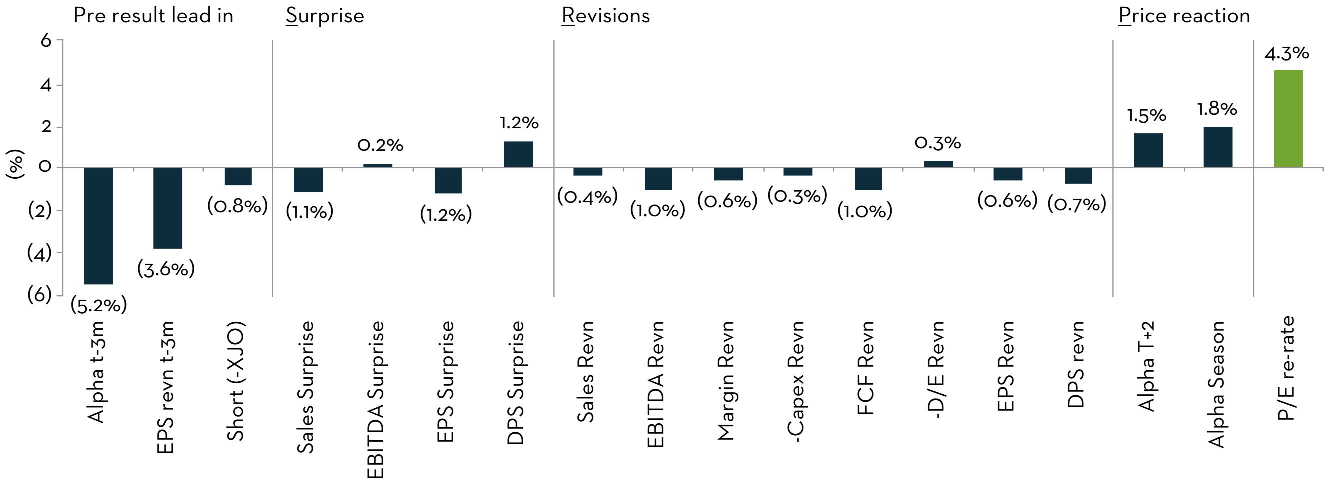
No matter what the direction of market sentiment is, our analysts continue to focus on the true fundamentals which drive companies' long-term earnings power. We understand that periods of market disconnect can offer significant opportunities for research-driven stock picking.

Our 150+ meetings during this most recent reporting period have enabled us to gain a better understanding of the real issues and strategies of each business, that we can then use to refine our views on each investment case.

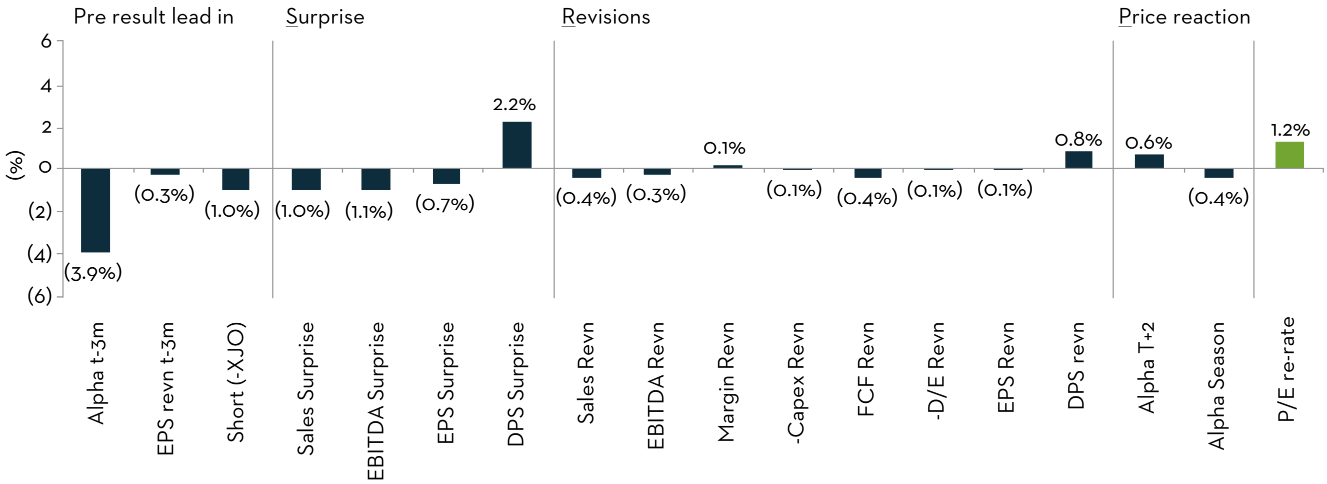
On the back of our analysis, we have adjusted consumer exposure away from housing, taken advantage of weather-induced selloffs and increased exposure to unloved stocks with improving underlying fundamentals.

## SUMMARY OF THE SEASON[5]

### Value Equity Scorecard (relative to S&P/ASX 200)




### Equity Income Scorecard (relative to S&P/ASX 200)




**Past performance is not a guide to future returns. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.**

Source: Martin Currie Australia, Factset; as of 28 February 2019. Data for the S&P/ASX 200 Index. 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.

[5]Data shown for a representative account.

## KEY DEFINITIONS WE USE

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

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

*Follow on 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.

*P/E rerate:* change in price during the season versus the change in broker consensus EPS forecasts over the same period.

*Alpha Season:* relative performance during the season.

**ACTIVE VIEWPOINT is just one part of our range of investment materials. To access further perspectives on our strategies and key investment themes, visit: www.martincurrie.com**

## FIND OUT MORE

For further information on the Martin Currie Australian equities range please visit our website – **www.martincurrie.com**
You can find your local contact at **www.martincurrie.com/contact_us**

Alternatively please call our global offices, press office or global consultant team on the numbers below:


Edinburgh (headquarters)
44 (0) 131 229 5252

London
44 (0) 20 7065 5970

Asia and Australia
(61) 3 9017 8640

Global consultants
44 (0) 131 479 5954

New York
1 (212) 805 6000

Media
44 (0) 131 479 5892

# IMPORTANT INFORMATION

This information is issued and approved by Martin Currie Investment Management Limited ('MCIM'). It does not constitute investment advice.

**Past performance is not a guide to future returns.**

The information contained in this presentation has been compiled with considerable care to ensure its accuracy. But no representation or warranty, express or implied, is made to its accuracy or completeness. Market and currency movements may cause the capital value of shares, and the income from them, to fall as well as rise and you may get back less than you invested.

This document has been prepared for professional investors, it is intended for the recipient only and may not be distributed to third parties. The document does not form the basis of, nor should it be relied upon in connection with, any subsequent contract or agreement. It does not constitute, and may not be used for the purpose of, an offer or invitation to subscribe for or otherwise acquire shares in any of the products mentioned.

Martin Currie has procured any research or analysis contained in this presentation for its own use. It is provided to you only incidentally, and any opinions expressed are subject to change without notice. The opinions contained in this document are those of the named manager(s). They may not necessarily represent the views of other Martin Currie managers, strategies or funds. Please note the information within this report has been produced internally using unaudited data and has not been independently verified. Whilst every effort has been made to ensure its accuracy, no guarantee can be given.

Some of the information provided in this document has been compiled using data from a representative account. This account has been chosen on the basis it is an existing account managed by Martin Currie, within the strategy referred to in this document. Representative accounts for each strategy have been chosen on the basis that they are the longest running account for the strategy. This data has been provided as an illustration only, the figures should not be relied upon as an indication of future performance. The data provided for this account may be different to other accounts following the same strategy. The information should not be considered as comprehensive and additional information and disclosure should be sought ahead of any planned investment. The distribution of specific products is restricted in certain jurisdictions, investors should be aware of these restrictions before requesting further specific information.

**Risk warnings – Investors should also be aware of the following risk factors which may be applicable to the strategy shown in this document.**

- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- These strategies may hold a limited number of investments. If one of these investments falls in value, this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- Income strategy charges are deducted from capital. Because of this, the level of income may be higher but the growth potential of the capital value of the investment may be reduced.
- These strategies may invest in derivatives (index futures) to obtain, increase or reduce exposure to underlying assets. The use of derivatives may restrict potential gains and may result in greater fluctuations of returns for the portfolio. Certain types of derivatives may become difficult to purchase or sell in such market conditions.

**The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were or will prove to be profitable.**

**Any distribution of this material in Australia is by Martin Currie Australia ('MCA'). Martin Currie Australia is a division of Legg Mason Asset Management Australia Limited (ABN 76 004 835 849). Legg Mason Asset Management Australia Limited holds an Australian Financial Services Licence (AFSL No. AFSL240827) issued pursuant to the Corporations Act 2001.**

**For Investors in the USA, the information contained within this document is for Institutional Investors only who meet the definition of Accredited Investor as defined in Rule 501 of the United States Securities Act of 1933, as amended ('The 1933 Act') and the definition of Qualified Purchasers as defined in section 2 (a) (51) (A) of the United States Investment Company Act of 1940, as amended ('the 1940 Act'). It is not for intended for use by members of the general public.**

MARTIN CURRIE
A Legg Mason Company