IntelligentInvestor.com.au

Reporting Season Winners & Losers

Special Report | September 2015

INTELLIGENT INVESTOR

Reporting Season Winners & Losers

If investors have learnt one thing from the 2015 reporting season it's that they can't have their cake and eat it, too. John Addis asks the team for their thoughts.

Investors and managers alike were on their knees, genuflecting before the God of Yield.

After 44 detailed reviews of company results and countless Alerts, it's with a sigh of relief and exhaustion that reporting season is now officially over. Although we have some results yet to cover, a few themes have emerged.

As bond markets travelled south, there was a certain inevitability about investors piling into high yielding and apparently safe stocks like **Telstra** and the banks. Less predictable was the extent to which this trend would have been absorbed by CEOs and their boards. Investors and managers alike were on their knees, genuflecting before the God of Yield.

For the 2015 financial year, ASX 200 dividends (including special dividends) were up 6.5% over 2014, a figure which is having a distorting effect on capital allocation. As Gaurav Sodhi says: 'The payout ratios on the ASX have never been higher. Companies are being punished for investing in growth at the expense of dividends, resulting in some odd behaviour.'

BHP Billiton, for example, has said decisions about dividend payments are made before those related to investing in the business. This volte-face reveals the absurdities of this post-GFC, low rate period. Boards once had the confidence to make capital allocation decisions on behalf of investors. If it was deemed a certain percentage of annual profit could be reinvested at rates higher than shareholders could realistically expect to invest themselves, that's what would happen.

No longer apparently. The narrow-minded pursuit of dividends has turned a resources giant into a cash cow at a time when we're surely closer to the bottom than the top of the resources cycle.

This reversal is spinning heads everywhere, including at CommSec, where an **Economic Insight** from late last month declared that 'there is no sense that companies have blinkers on with a single-minded determination to pay dividends at all costs. Rather companies are competing for the affection of current or prospective shareholders.' To this observer that sounds pretty much like the same thing.

The same report notes that the proportion of ASX 200 companies paying a divided has climbed from 83% to 91% in the past five years. Long-term investors will pay a future price for cash in their hands now.

The upside, as usual, is through the looking glass. Businesses that *are* investing in growth, such as **Trade Me**, **Carsales** and **News Corp** – all on our **Buy list** – appear to be paying a price for swimming against the tide. If you're looking for the counter-cyclical play this area of the market is an attractive place to kick a few tyres.

What else? No doubt those boards writing hefty dividend cheques would point to recent economic data as evidence of their sangfroid. With GDP growing by just 0.2% in the June quarter, growth expectations are moderating. For some companies highly leveraged to the wider economy, or China, pulling back on investment makes sense.

For others, dividends are the easy way out. One of the main benefits of investing is that over time the returns from stocks beats general GDP growth. That only occurs because businesses create new opportunities, acquire weaker competitors, expand and become more efficient and profitable in what they do. To accept things as they are is a silent rebuttal of this central truth.

Right now, too many Australian businesses are happy with the status quo. And yet the components of the recent underwhelming GDP growth figure suggest that it's really only the mining sector that's suffering. Most others, from construction to retail to agriculture, are trundling along rather nicely.

Don't be surprised to see the more languid pockets of Corporate Australia popping up on the lists of potential takeover targets of more ambitious foreign companies (see ***Don't discount a takeover for Woolworths***).

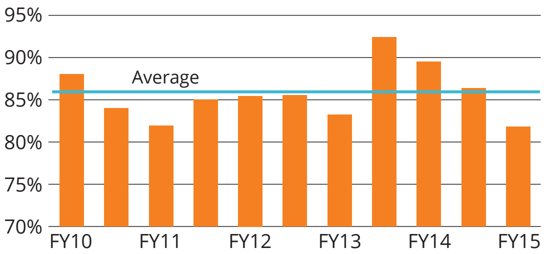
And yet despite the pessimism and lethargy, this isn't a cheap market. The ASX 200 forward price-earnings ratio is slightly over its long-term average of 15.5. If we are to find opportunities, we need to dig much deeper, which takes us neatly into the more interesting sectors of reporting season, starting with the banks.

James Carlisle, research director

Revenue growth has been slowing among the big banks for a few years, but high single or double-digit rates of earnings growth have been supported by falling loan impairment charges. With impairments probably as low as they can go, lower economic growth is starting to show through.

> *With impairments probably as low as they can go, lower economic growth is starting to show through.*

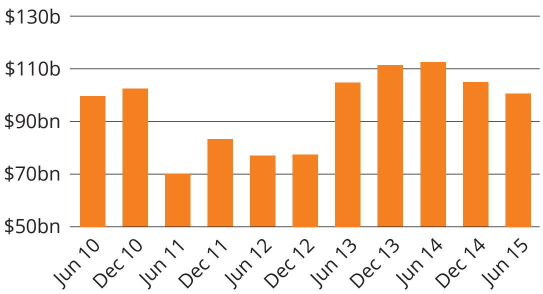
Chart 1: Proportion of ASX 200 companies producing a profit



Source: CommSec – reproduction of CommSec chart

Commonwealth Bank could only muster 5% cash earnings growth for 2015. The others are expected to fare slightly worse when they report in October (although **NAB** will be flattered by reduced one-off items). The swag of capital raisings won't help next year's figures, either. Thanks to slow top-line growth, bad debts ticking up and dilution from capital raisings, the big four are likely to show cash earnings per share growth of close to zero in 2016. With a bit of luck, this might develop into an opportunity.

Chart 2: Cash on hand of ASX 200 companies reporting results at end period

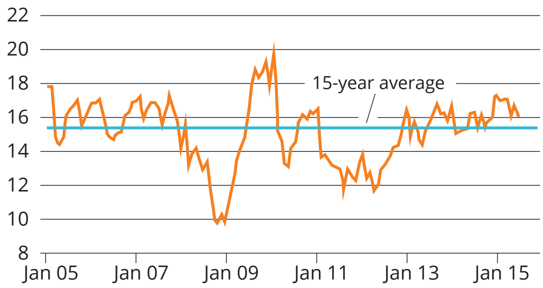


Source: CommSec; ASX – reproduction of CommSec chart

Elsewhere in the financial sector, fund managers enjoyed a decent rise in profits, with **Perpetual**'s underlying earnings per share up 19%, for example, and **Platinum Asset Management**'s up 13%. Pleasingly, Perpetual revealed a return to fund inflows (of $449m up to 21 Aug) after the $1.7bn outflow in the fourth quarter. Markets have deteriorated in the two weeks since and there will no doubt have been outflows, but this was a welcome improvement.

The sector's results were largely due to rises in global sharemarkets. With funds under management likely to fall in 2016, most will struggle to increase earnings per share as a result.

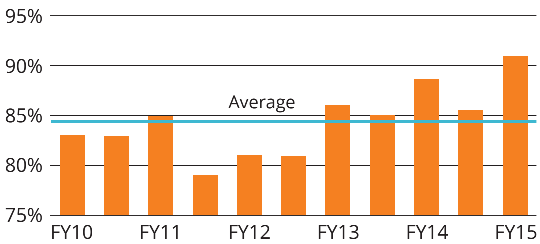
Chart 3: All Ordinaries forward Price Earnings ratio



Source: CommSec; FactSet – reproduction of CommSec chart

Other stocks have had a boost from the lower Aussie dollar. **ResMed** and **Computershare**'s profit growth translated well into Aussie dollars, but in US dollars (their reporting currency), ResMed's net profit rose just 2% and Computershare's fell 1%.

Chart 4: Proportion of ASX 200 companies issuing a dividend



Source: CommSec – reproduction of CommSec chart

Computershare's result was particularly poor but the greater shock was the guidance that earnings per share for 2016 would fall by around 7.5%. None of this is as bad as it sounds for Australian investors, for whom the currency effects are unwound when the earnings are translated back into Aussie dollars. More worrying are the low interest rates, which show few signs of abating. Still, that's why the stock is cheap and we can be patient.

> *Each thematic wave leaves in its wake a host of mispriced stocks.*

Overall, though, this reporting season makes clear that profit growth of 0–5% is the new 5–10%. Investors are going to have to pare back their growth expectations, leaving many short of the returns they desire. After the 'rush to yield', recent falls might be the start of a 'flight from stagnation'.

Is that reason for alarm? Not really. Each thematic wave leaves in its wake a host of mispriced stocks. The online classifieds businesses are good examples, where slow rates of growth mask a promising future. Cost increases were behind lacklustre profit performances from **Carsales** (underlying EPS up 4%), **Trade Me** (underlying EPS up 3%) and **Seek** (underlying EPS up 6%) but these are companies making sensible investments at the right time.

They are to be applauded for their willingness to invest, despite incurring the wrath of investors. Companies that are prepared to do the right thing for their businesses over the long term are likely to make the better investments.

GBST was possibly the most notable result among the stocks I cover, not particularly because of the result – which was excellent and reinforced our Buy recommendation – but because of the reaction to it. The shares jumped 8% on the day but have since fallen 21%. It's possible we're missing something but the more likely explanation is that this is an excellent opportunity.

James Greenhalgh, senior analyst

I'd first like to endorse James' comments on the online classifieds stocks. Lots of companies grew revenue at a faster rate than profit, or forecast that would be the case in 2016, including Seek, Carsales and **Veda**. This means that costs are blowing out, or that past capital expenditure will come through future profit and loss statements as future depreciation and amortisation.

This is the downside of capital investment – future profits can be hit by higher depreciation expenses until the capital investment generates additional earnings (which can take time). In addition, higher than expected capital expenditure can mean that future free cash flows are less than expected, which is likely to be the case with Veda. Members following our positive recommendations in this sector need to understand this dynamic.

It's almost a running joke that, as soon as a former private equity owner sells out, skeletons begin a long crawl from the closet onto the profit and loss account. Certainly that was the case with Veda Group. Elsewhere, companies that were the subject of failed private equity takeovers last year, such as **SAI Global** and **Treasury Wine Estates**, reported excellent results as new management improved the businesses, demonstrating that private equity targets are potentially under-earning and can do better under new management.

The media sector was another that caught my eye. The story of the newspaper publishers was twofold. First, cost cutting in previous periods meant that earnings fell less than expected at **News Corporation** and **Fairfax Media**. Even declining businesses can take steps to reduce the structural issues facing their industries, meaning the decline can be slower than expected.

Second, these publishers have been able to use their legacy businesses to increase the value of their other assets. Fairfax, for example, has been able to improve the performance of Domain while News has been driving traffic to its recently acquired real estate website realtor.com (Move).

For Fairfax the question is whether the growing parts of these businesses can outpace the declines in the traditional print businesses. For News, where the five surprises in its recent result were all pleasant, the story is improving, which is why the stock remains on our Buy List.

In retail, the long period of supermarket earnings growth is at an end. Woolworths let margins expand rather than reduce prices for customers in recent years, while **Wesfarmers**' Coles produced just 7% earnings growth this period as the turnaround tails off. With Aldi gaining market share, the easy gains are over and Woolworths has most to lose.

Thus we find a high quality company sleep-walking into a difficult next few years. The result was in line with expectations but margins and profits have to come down. There's lots of uncertainty about future profitability but the widespread recognition of this fact explains why the stock's price is hovering just above our Buy price.

There's a lot of pain in department stores, too. Woolworths' Big W and **Myer** reported much lower profits and Target's margins are far lower than historically. Only Kmart is performing well and its margins look too high. Overall, department stores are in a lot of pain, although maybe that indicates turnaround potential. Private equity anyone?

My standout winner was **Flight Centre**. For years

With commodities plummeting, the profitability of miners and drillers has fallen, too. No surprises there.

the market has been expecting an incursion from online competition but it simply hasn't happened. Instead, the slightly weaker Aussie dollar caused a small profit fall in Australia but the international operations saved the day. The company's business looks stronger than either I or the market expected. Below $30 we'd look at an upgrade.

Gaurav Sodhi, deputy research director

Investors tend to think of miners as slaves to commodity price changes. With commodities plummeting, the profitability of miners and drillers has fallen, too. No surprises there. What has surprised me is the extent to which they've managed to control their costs in the face of rapid price falls. **Fortescue Metals**, for example, has cut its cost of production from about $60 a tonne a few years ago to about $30 now. Many producers have achieved similarly impressive cost cuts, something that I would not have considered possible.

The big, higher quality miners have done this better but smaller miners with lower quality deposits have also surprised. **Atlas Iron**, for example, came back from the brink following innovative cost cuts involving suppliers and profit sharing.

The other key lesson from the sector is that contracts that we previously thought were worth a good deal are in fact worth nothing. Several of our high-risk picks in the mining services sector looked okay on paper but had contracts snatched away or revoked. That risk is impossible to pick, which is why these stocks are highly speculative.

The market thought otherwise but my two picks for most impressive reporting season performance are BHP and **South32**. Both posted excellent results, characterised by high cash flow, great cost control and resilience to lower prices. South32 especially seems cheap given the amount of cash being produced and the prospect of lower costs ahead. Other, less prominent, highlights were **PMP**, which is quietly generating copious cash flows, and **Woodside**, which has made the most of its strong balance sheet to launch a merger with Oil Search.

The energy sector hasn't shown the same resilience as the miners. Cost cuts are harder to achieve, perhaps because less material is moved and there are fewer opportunities for management intervention. Without protection from falling oil prices – even when gas or LNG is produced rather than oil, margins on liquids are always the widest in a boom and narrow fast in the bust – this was an ugly reporting season for the sector. **Origin Energy**'s retail business performed very well but was overshadowed by lower returns from LNG. **Santos**'s results were disastrous and highlighted that the apparent stability of its gas business can be overwhelmed by volatile oil prices, which account for a small portion of production but a huge portion of profits.

Transpacific should also be noted for a terrible result that showed the business to be far more cyclical than we had originally thought.

Graham Witcomb, analyst

In contrast to the mining sector, most healthcare stocks posted excellent results, reinforcing the idea that they are resilient during poorer economic times. One interesting thing to watch will be the battle between the health insurers and **Ramsay** and **Healthscope** hospitals. Health insurers have seen a surge in lapses and policy downgrades, making them more aggressive in rate negotiations. Ramsay's rates are up for renegotiation next year so we can expect some heated news stories as the gorillas start beating their chests.

Cochlear was notable for demonstrating that share prices are based on expectations rather than results. The company posted record sales and a 56% rise in net profit – plus management guidance for net profit to increase 14–20% in 2016 at current exchange rates – yet the share price fell 10% on the day. The market expected better. Management may think twice before cutting the dividend again.

The other standouts were **Virtus Health** and **Monash IVF**, for two reasons: the results were better than expected and reinforced our view that **Primary Health Care** isn't a big threat. While Primary has taken market share, it has been achieved by growing the market. Not only did it not poach customers, it actually helped Virtus boost NSW cycles by 4.5% due to the added publicity of low-cost IVF.

Both companies also managed price increases, with management indicating more are likely for their full-service offerings. Pricing pressure from Primary was my biggest worry for these businesses but it hasn't shown itself, at least not yet.

The other reason they stand out is that, while the share prices did pop, they are still well off their highs when the Primary saga began. With both on free cash flow yields above 7%, these are attractive businesses growing in the mid-single digits and requiring almost no operating capital.

Jon Mills, junior analyst

Property trusts continue to benefit from low interest rates, enabling cheaper debt refinancing and putting a downward pressure on capitalisation rates. 'Long WALE' assets – those assets leased to high quality tenants on long-term leases – have been particularly favoured, a fact evident in the result of **ALE Property** (LEP), whose pubs are on long-term leases to a Woolworths subsidiary and now have an average capitalisation rate below 6%.

The decline in the Aussie dollar and the higher yields foreign investors can obtain here ... have also helped.

The decline in the Aussie dollar and the higher yields foreign investors can obtain here – despite prices already being high – have also helped, particularly in Sydney and Melbourne. One example is the $2.5bn China Investment Corporation recently paid for Investa Property Group's portfolio of nine office towers, mostly located in those two cities. The initial passing yield of 5% is particularly 'sharp' as they say in property land but it does rise to 5.7% once fully leased.

Another interesting theme is how well the theatre divisions of **Amalgamated Holdings** and **Village Roadshow** have done as a result of the plethora of blockbusters released during 2015. Despite bigger and better quality TV screens and the rise of streaming services such as Netflix, it looks as though movie theatres aren't dead yet, assuming Hollywood continues to release popular films – a big 'if' perhaps.

Note: Our Growth Portfolio owns shares in Computershare, Perpetual, ResMed, Carsales, GBST and Trade Me. Our Income Portfolio owns shares in CBA, Computershare, Perpetual, Woolworths, Carsales, GBST and and Trade Me.

Disclosure: John Addis owns shares in GBST, ResMed and Computershare. James Carlisle owns shares in GBST, Trade Me, News Corp and Virtus Health. James Greenhalgh owns shares in Trade Me, Commonwealth Bank, Platinum Asset Mgmt, Computershare, SAI Global, Fairfax Media, Cochlear and Virtus Health. Jon Mills owns shares in Trade Me and Virtus Health.

INTELLIGENT
INVESTOR

PO Box 2801 Bowral NSW 2576 | 1800 620 414

info@intelligentinvestor.com.au
intelligentinvestor.com.au