

Consider risks, but future looks positive

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Philip Baker, David Ciampa and Peter Wells

While shareholders might be annoyed at companies not distributing more of their profits this reporting season, industry experts understand the cautious approach, with certain caveats. Australia's two-speed economy is confirmed, but investors are advised not to neglect stocks leveraged to the domestic economy, as growth in the resources sector appears to be priced in.

What was the key message for investors from the reporting season?

Kate Howitt : This round of results demonstrated that the "two-speed economy" is very much intact. Mining stocks and those leveraged to mining delivered to expectations and look set to continue their growth. In contrast, businesses leveraged to Australian households fared less well and their management teams remain uncertain about near-term trading conditions.

A second thematic was the strength of the Australian dollar, which had a dampening impact on the results of all companies which sell their goods and services into overseas markets. In the commodity space, this has been offset by the rise in \$US-denominated commodity prices, but for industrial businesses there has been no silver lining to the translation impact.

Chris Stott : Generally the results season was in line with expectations to slightly better. Once again it was very stock and sector specific with positive results coming from the resources sector and mixed outcomes from the industrials. The key message was that we had further evidence and confirmation of the two-speed economy that exists in Australia. Resources companies as a whole continue to be rampant with demand from China not slowing down. Capital expenditure is forecast to reach record levels in the next two to three years, driven predominantly out of Western Australia. Meanwhile the industrials sector continues to lag under the pressure of an Australian economy that was subject to seven interest rate rises over 13 months.

David Paradise : Overall sales lifted 14 per cent against an 11 per cent increase in expenses, however, this is somewhat deceptive. Some sectors grew a lot faster than others, proving that the two-tiered economy is evident. The resources-based companies continued to grow strongly and many traditional industrial companies continue to struggle. However, the banks continued to deliver strong results.

Naz Ressas : US monetary easing has provided a lot of oxygen for the resource sector through higher commodity prices. The key question is how much of this is real demand. Industrial earnings couldn't match the momentum of the commodity price run. A number of the Australian listed industrials have a high proportion of US dollars earnings, which have borne the brunt of the easy US monetary policy through a weak US dollar – the flipside of the commodity equation.

Crispin Murray : Firstly, the domestic economy is weaker than most people realise. Retailers had a soft Christmas and January sales season and manufacturing companies are struggling due to a lack of end demand and the impact of a strong \$A encouraging import competition. Secondly, the recovery in the US is still patchy. Housing has not yet seen a recovery and the consumer exposed companies are not seeing a sustained recovery in demand. Thirdly – on a more positive front – the long awaited recovery in investment spending, particularly on the commodity projects, is finally beginning



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"Given the weak top-line environment, stocks that can grow market share, take costs out or divest undervalued assets to realise value appeal to me." **NAZ RESSAS**, Colonial First State portfolio manager



"We are generally contrarian investors and prefer not to invest in last year's winners. As a result we are cautious about investing in resources at this stage of the cycle. Commodity prices need to remain high to justify current valuations." **DAVID PARADICE**,

to ratchet up after several months of delays.

Overall the numbers were disappointing, however, the market performed well as it was already discounting a weaker environment and many investors believe that within six months we will see more clear signs of a US recovery and an investment pick-up in Australia.

Industrials disappointed: do you think they can recover?

Howitt : There are a range of industrial companies with very bright outlooks, such as mining service companies and engineering firms which are benefiting from the boom in mining-related capital expenditure.

However, \$US earners (such as health care companies, a range of building products and transport companies) have seen their reported growth impacted by the strong \$A. But in most cases their underlying growth remains intact or is even benefitting from the incremental strength of the US economy. As US growth gains traction and the \$A\$ reverses, or at least stabilises at these levels, these firms can deliver reasonable growth.

Stott : The industrials disappointed but this was expected. Earnings expectations have been revised down over the past 12 months to now where the ex-materials earnings growth stands at 6 per cent for FY11, down from the lofty heights initially forecast of 20 per cent. Selected industrials look attractive at current levels and there are some buying opportunities appearing. Monetary policy as always will be key here. With the Reserve Bank seemingly on hold in the short term with interest rates, this could provide earnings growth for the industrials sector over the next 12 months. We focus on the small industrials sector of which we like Breville, STW Communications Group and Credit Corp.

Paradice : Some industrial companies are structurally flawed and with these investors need to be careful not to fall into value traps. However, there are some that are going through a rough trot at the moment but they have a point of difference that can be managed by excellent management to deliver strong returns through the cycle. Stocks which have a price at which the stock can be bought and fit into this category are Virgin Blue and Bradken.

Ressas : Industrial stocks are very cheap, trading at about 12x forward earnings, which is pretty much a low over the past 15 years outside of the global financial crisis. Considering the current weak top-line environment, stocks that can grow market share, take costs out or divest undervalued assets to realise value appeal to me. For example, Wesfarmers through what it is doing with its Coles business, is taking share and margin from its competitors; Asciano with its above-system coal growth in Queensland and potential ports divestment; and Brambles is winning back business from new entrants plus entering new geographies and segments like auto-crates.

Murray : Industrials have had to deal with the combination of rising interest rates, a strong \$A, a rise in discretionary saving, poor weather, natural disasters and delays to resource projects. So it was not surprising to see them disappoint on earnings. The key call now is whether we are at a cycle turning point. In a number of cases we believe this is the case, notably the engineering sector where the wave of new projects will be getting started, such as Gladstone LNG, Pilbara iron ore and Wheatstone. We also believe those companies exposed to the US will see improved demand conditions. While it may not be a strong recovery there is still considerable operating leverage in companies like Incitec Pivot and Brambles. Investors do need to be mindful that in some cases the hoped for recovery in industrials will not materialise. The domestic steel industry is having it tough for both cyclical and structural reasons, due to the rise of input costs and excess global capacity, and the pick-up in earnings may not come through as quickly as expected.

Were you happy with the level of dividends and capital management?

Howitt : Corporate balance sheets became too stretched in the run-up to the 2008 downturn, so when business conditions worsened many corporates found themselves in breach of their banking covenants or in financial distress from onerous interest expense. Fortunately, our market was able to recapitalise –the larger corporates much more easily than was possible in many other Western markets. So now with more buoyant

Paradice Investment Management portfolio manager



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CHRIS STOTT, Wilson Asset Management portfolio manager

conditions, many corporates find themselves with balance sheets that are verging on "lazy". For companies which do carry surplus cash, we would prefer to see capital management than watch them overpay on acquisitions.

Stott : Dividends and capital management were expected to be a theme for reporting season and delivered. There was a heightened level of commentary around capital management post the GFC with corporate balance sheets in strong positions. Companies have raised money expecting to find assets delivering similar or better returns to their current businesses, but in some cases they have struggled. News around capital management will become louder over the next six months if capital can't be adequately deployed. Notables from reporting season from a capital management sense were BHP Billiton, Rio Tinto and OZ Minerals.

Paradice : Generally yes. As the outlook is uncertain and the confidence of companies is low given their experience over the global financial crisis, companies have been generally conservative resulting in cash levels up 51 per cent to \$50 billion. We would prefer them to be conservative and preserve cash as acquisitions should generally provide better returns over the longer term rather than paying out all the cash to shareholders. We do believe in dividends, as it generally shows us management are comfortable about their company's future. One of drivers of share price growth is long term growth in dividends.

Ressas : For the most part boards and management remain conservative. While high payout ratios may be applauded by some in the market it probably won't have an enduring impact on stock prices; if anything it could make companies more vulnerable should global growth decline. My preference is that they try to allocate capital to high return projects while demand remains weak and asset prices are attractive. Macquarie Group and QBE are a good example of this – they could easily up their dividend but instead are making attractive acquisitions like Delaware Investment and Balboa. Return on equity on these deals are well ahead of both companies' cost of capital.

Murray : We were not expecting much upside to the level of dividend payouts, given most companies have clearly articulated their approach and are mindful now of the need to fund organic growth from internal cash flow and that the market, for the time being, sees through any attempt to fabricate extra yield. The big buybacks from the miners were as expected, we don't get too concerned about the stated time frames as this is more about giving them an out in the event of an unforeseen sharp drop in commodity prices. If prices stay as the market believes, we would anticipate and expect the buybacks to be completed sooner than stated.

The resources sector was the standout, but is it all priced in? Should investors keep buying?

Howitt : Most small miners have outperformed recently as the rise in commodity prices has been factored into their outlooks. In 2006 we saw 100 per cent of small miners in the S&P/ASX 200 on a negative free cash flow yield. This meant all of the net cash these businesses generated was being poured back into growth investments. In the downturn this eased to about 60 per cent, but has climbed back up to over 80 per cent. Whether this increased investment delivers for shareholders will depend on the delicate balance between China's continued growth in demand, versus new supply coming on. This will vary, commodity by commodity, mine by mine and company by company.

At these share prices the risk to investors is certainly much higher and they should be increasingly discerning. Companies with the most marginal business models have had the most leveraged rebound, but they are also the ones which will fall the most in any bout of commodity price weakness. The larger miners offer less risk in a downturn, and yet they are being priced at no premium to the smaller, less-diversified miners.

Stott : The resources sector has been a very strong performer for the broader Australian market over the past 12 months. We are cautious on the sector over the next six to 12 months and see future growth priced in. Chinese growth will slow from its heights in recent years to high single digit which could provide downward pressure on commodity prices. With many commodities trading at record highs we remain cautious, in particular at the smaller end of the market.

Paradice : We are generally contrarian investors and prefer not to invest in last year's winners. As a result we are cautious about investing in resources at this stage of the cycle. Commodity prices need to remain high to justify current valuations. However, the outlook in this regard remains uncertain with such issues as inflation in China being a risk to commodity prices. We prefer to invest when there is little or no need to have high expectations to justify share prices and thus we tend to have a bias towards industrials and an underweight exposure to resources.

Ressas : The real delta in commodity prices of late has been US monetary easing and geopolitical dislocation - not real demand. The fact remains that China is tightening and a lot of good news is cooked into current resource prices. The real question is are we paying 10x prospective earnings or 30x if prices come off.

Murray : In 2010 the introduction of QE2 in combination with continued strong Chinese demand drove a strong rise in commodity prices which led to the sharp rally in resources, particularly at the small- and mid-sized end. For 2011 we see the focus being on the ability for commodities to hold the current high prices. The

two risks to prices are Chinese inflation triggering a policy response that hits demand or a sustained spike in oil prices which would hit global demand. We don't as yet see this occurring, which should lead to commodities prices remaining firm. In this environment investors should expect the sector to perform well, but not be as strong as last year and in addition see a shift of leadership in the sector away from the prospective mine plays towards the companies on low valuations generating high levels of cash, such as Rio and BHP. We also expect oil and gas stocks to perform better this year as the stronger growth in the developed world has more impact on demand than it would for metals, which are more geared to China.

Where do you see stocks going this year?

Howitt : So far our market has followed the script for a large downturn: first the massive sell-off, then the big rebound, then the slow volatile upward grind. If we continue to track to previous market patterns from here, we could expect to see the gains increase. This is also in line with the fundamentals we see: valuation levels remain attractive, below historical levels, and our Asian trading partners remain in good shape with strong demand for our resources. At some point, the marginal strength in the economy will tip back the other way, which leads to two risks for investors. On a fundamental level, monetary policy errors remain a possibility; though Australia's excellent policy transmission through variable rate mortgages means we can expect the RBA to be nimble and responsive as conditions change. From a sentiment point of view, investors need to be wary of solely chasing the optimism in the resource-related space where much is already priced in, and shunning those stocks leveraged to the domestic economy. With the household savings rate running at about 10 per cent there is certainly room for Aussie consumption to surprise on the upside.

Supporting these factors, Australia's long term drivers remain intact:

- high population growth,
- excellent and low cost natural resource base,
- good corporate governance and
- a high dividend yield and
- high real dividend growth.

What are the main risks for investors?

We are likely to see the two speed economy continue, as the Reserve Bank of Australia (RBA) uses interest rates to contain growth in the household sector in order to accommodate the "positive shock" from the ongoing strength in resources. Households have been responding prudently to this environment by pulling back on spending and investing in property with less exuberance. There are no signs that these conditions will change in the near-term, so caution is warranted for smaller discretionary retailers, those exposed to residential property and the like.

Stott : We will continue to see the US market outperforming the Australian market as the US economy is still in recovery mode. With a high \$A, US equities look attractive over the next six to 12 months. In Australia I expect the market will continue to trade relatively sideways in a band between 4600-5000 as the impact of last year's interest rate rises flows through the economy. This period could provide some great opportunities with equities looking cheap at 12.5x versus the long term average of 15x. The greatest risks to the above are growth out of China slowing, potentially reducing demand for commodities along with domestic interest rates being pushed higher to control inflation and wages growth.

Paradise: During the season companies reported that through the December half the consumer had been generally weak and the strength of the economy has been clouded in some areas due to the floods. However some of the leading economic indicators are suggesting consumers are becoming cautiously positive. This has been supported by some of the companies which are seeing patches of consumer strength. As a result we are generally positively disposed towards the market. The continued pick-up in the US would indicate there will not be a double dip. However, this has resulted in a strong equity market which many believe is due for a breather. This is one of the short-term risks to a rally in our market. Other risks include rising interest rates, inflation and the currency. There is also another risk. Some investors believe commodity prices continue to go up in a straight line, that the rules of supply and demand don't apply any more and that high returns on capital are the norm for price-taking businesses.

Ressas : Outside of wildcard geopolitical risks, the main risk is if the US recovery falters, that is high inflation precedes consumer and business demand or the demand simply fails to follow through.

Murray : Market valuations are below long-term averages, sentiment towards equities is low and global economic growth is improving. In combination this should lead to a good rate of return for investors. There are risks, but it is the fear of these that creates the opportunity. The most immediate are the removal of liquidity from both China and the US. Markets corrected last year after the Fed stopped its first quantitative easing program; the current QE program is due to finish by the end of June and the market will begin to anticipate

that earlier. So we could see a correction in the market during the second quarter, however, unlike last year we believe the recovery in the developed world will prove more resilient this time and any pullback would represent an opportunity for investors. Other risks relate to excessive sovereign debt levels and an excessive rise in the oil price triggered by geopolitical risk. The latter is a wild card, but the former is important to consider. Our view is that this will constrain longer-term growth. Australia is, however, fortunate in not having such a debt burden and being predominantly leveraged to Asia.

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