

## Number in line for confession

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Leighton Holdings' \$907 million earnings downgrade is not expected to be the last of its kind as investors brace for the effects of natural disasters, adverse currency swings and soft consumer sentiment on corporate bottom lines.

The so-called "confession season" is only a few weeks away, but companies including Virgin Blue, Myer, JB Hi-Fi, Metcash, Macmahon Holdings, transport junior K&S Corporation, Billabong, and Adelaide Brighton are among companies that have already downgraded guidance, some more than once, this financial year.

Fund managers anticipate more downgrades from companies, particularly in the industrials ex-financials space, in May and June due to several factors that include rising raw material costs, increased competitive pressures or price deflation.

"Another lost year of profit growth is looming and there doesn't seem to be relief for the non-bank industrials given the economy seems to be treading water and moving sideways," Wavestone Capital principal Ian Harding said.

Until the market could see evidence of a lower Australian dollar and interest rates, Mr Harding said the non-bank industrial sector had "heavy weather" to get through, resulting in downgrades to earnings growth expectations due to overly generous forecasts.

"The major risk is not so much for earnings for the year to June but the changed expectations in the following year, which are still way too high given that revenue growth appears pretty tepid and input growth pressures exist."

Mr Harding views Goodman Fielder as a downgrade candidate due to higher grain costs and increased hedge costs.

In addition he said Toll Holdings was at risk of a downgrade due to the potential difficulty in passing on rising fuel costs.

"You can see what the mining boom is doing to the economy and I don't see anything altering that... This is the downside of a mining upside," Mr Harding added.

Evergreen Capital chief investment officer Tim Hannon said the fund has a short position in Toll Holdings on the expectation it will get hit by rising labour and fuel costs as well as a weak domestic economy, particularly in the retail sector.

"Its Asian expansion strategy may be causing some issues and we have seen evidence of falling margins and attempts by Toll in its last result to make the result look better than it was, while Paul Little's departure is a short-term concern and somewhere we can draw similarities to Leighton Holdings."

Companies with large offshore earnings exposures are also seen as another at-risk area of the market.

"Aristocrat Leisure is due for another downgrade," Investors Mutual senior portfolio manager Hugh Giddy said.

"A stock such as Caltex has been very strong but I think people have optimistic assumptions because higher fuel prices don't necessarily mean they're making good money because the oil price is also higher," he said.

US housing starts are no longer plunging, but Mr Giddy said investors weren't too spooked by the outlook for Boral and James Hardie Industries. "People ignore the earnings outlook because they're so focused on the turnaround that they believe will happen," he said.

Elsewhere, Mr Giddy said weakness in property given low auction clearances could affect furniture and electronic retailers such as Fantastic Furniture, Nick Scali and Harvey Norman.

Meanwhile, developers such as Stockland Group, Lend Lease Group and Mirvac Group could encounter difficulty selling or leasing their projects, he said.

Goldman Sachs thinks MAp Group, Australian Infrastructure Fund and Qantas are potential downgrade candidates due to recent catastrophic events coupled with rising oil prices and weak domestic demand.

Mr Giddy noted Qantas had been heavily discounting in order to fill its planes, though, and said "If fares are down and oil prices are high, that will squeeze their margin, but if they can fill seats by discounting, that's better than nothing."

Telstra is another of the broker's potential disappointments due to pressure on the company's control of direct

variable costs.

Mr Giddy does not expect Telstra to be a downgrade candidate, noting the market is already expected Sensis's contribution to be weaker.

DMP Asset Management investment director Julian Mitchell believes there could be residual concern over Seek's education business and he also has a question mark over Macquarie Group's earnings.

"They just don't seem to be getting enough deals," he said.

Mr Mitchell thinks Computershare is challenged by a high Australian dollar.

Macquarie Equities Research names stocks including Billabong, CSL and ResMed among those to be hurt by the high Australian dollar. Goldman Sachs' candidates include Astro Japan Property Group, Infigen Energy, Transfield Services and again, ResMed.

"ResMed staggered its S9 launch which we think has lost them sales," said Mr Mitchell.

Also in healthcare, Goldman Sachs believes Primary Health Care is at risk of delivering results below consensus expectations given the potential for a higher interest expense than expected following cash flow issues in its medical centre business.

Mr Mitchell believes Asciano is at risk of a downgrade due to market share loss to Dubai Ports World. Maritime Union of Australia activity as well as higher input costs and a slower consumer.

Among the small caps, both Wilson Asset Management head of research Chris Stott and Celeste Funds Management chief investment officer Frank Villante said stocks with exposure to the discretionary dollar in Australia could be susceptible to downgrades, given softness in the apparel retail market, as per Myer's commentary last month.

"The consumer environment is just so different to how it was 12 months ago, people want to be recoiling in the fetal position rather than spend, though that doesn't last forever," said Mr Villante.

Both named Noni B, Specialty Fashion Group and Country Road as stocks that could struggle, while Mr Villante added Premier Investment Group and The Reject Shop to his list.

"You've also got the cotton price at record highs and that's a key input for their costs and they are also battling the weaker consumer," Mr Stott said.

In the information technology space, both fund managers named Oakton as a stock at risk of a downgrade due to its reliance on a big fourth quarter to achieve its guidance.

Hills Industries, Scott Corporation and Chalmers are three small stocks Mr Villante thinks could "find life a grind".

BlueScope Steel could be subject to a downgrade due to currency movements and the subdued steel market, Mr Stott said, but Pengana Capital portfolio manager Ric Ronge believes BlueScope could surprise on the upside despite currency concerns.

Mr Ronge believes QR National could be due for a downgrade as a result of weather-related damage to infrastructure.

Mr Villante disagreed, saying QR National had enough fat in the system, given its prudential padding.

Goldman Sachs believes Macarthur Coal has the greatest downside earnings risk.

Macquarie named stocks with fiscal 2012 earnings growth dependent on margin expansion or subject to operational vulnerability including CSR, Virgin Blue, Ten Network Holdings, Pacific Brands Group, Crown, Downer EDI, Macmahon Holdings and Foster's Group.

On the upside, Mr Ronge said Alacer Gold could issue an earnings upgrade if it produces more gold than expected in the near term.

"It'll be interesting to see whether someone like ARB Holdings upgrades earnings at the Macquarie conference next month, an occasion which companies use to fine tune earnings expectations," Mr Villante said.

Salmat is a stock he said that could surprise on the upside given investors are slightly too pessimistic about its earnings. "It's probably a bit better placed than people are giving it credit for," he said.

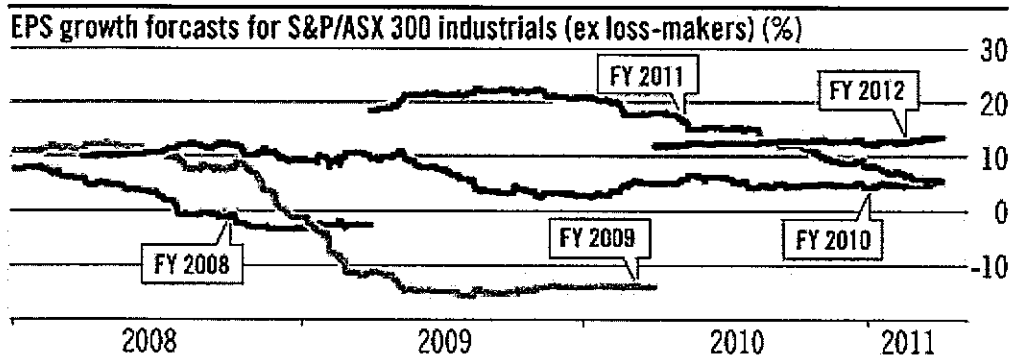
Mr Villante believes there only good news to come from companies such as Skilled Group and Austbrokers, as well as Breville Group, SMS Management & Technology and Data3.

Macquarie believes stocks with low risk to earnings growth forecasts include Coca-Cola Amatil, Ramsay Health Care, Wesfarmers, and UGL. Both Macquarie and Goldman Sachs named Bort Longyear as stocks with low risk to earnings growth.

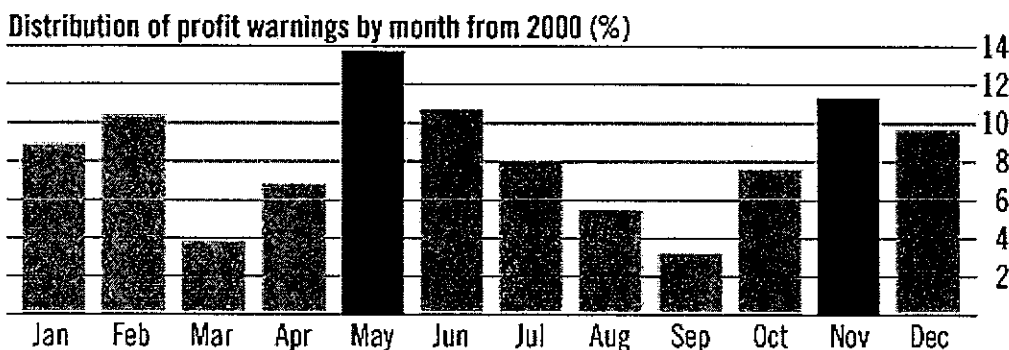
Stocks named by Goldman Sachs with the greatest earnings upside risk conflicted with those named by fund managers above as having downside risk.

Goldmans' list includes Aquarius Platinum, Challenger, Cochlear, Charter Hall Office REIT, Caltex, Equinox Minerals, GPT Group, Ilua Resources, Incitec Pivot, National Australia Bank, Newcrest Mining, Oil Search, OZ Minerals, PanAust, Stockland Group, Sonic Healthcare, Santos, Transurban Group, Westpac, Woodside Petroleum and Westfield Retail Trust.

## Saints and sinners



Analysts have downgraded fiscal 2011 growth assumptions and downgrades to fiscal 2012 growth are expected.



According to Goldman Sachs strategist Chris Pidcock, May and June are when 25% of the market's profit warnings have been made since 2000

SOURCE: GOLDMAN SACHS

The Australian Financial Review

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