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Ausbil HY19 Half-Year Season Wrap

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Key points

- The February half-year reporting season saw a derate of full year 2019 market EPS growth expectations by 0.5%, from 5.9% to 5.4%.
- Of the 32 sectors covered, EPS growth expectations were upgraded for 7 sectors, and downgraded for the remaining 25 sectors.
- Key sectors that were rerated included Metals & Mining, Capital Goods, Diversified Consumer Services, Energy, and Health Care Equipment & Services.
- Key sectors that were derated included Chemicals, Media, Software & Services, Life Insurance, and Real Estate.
- Post reporting season, EPS growth forecasts for FY19 and FY20 are expected to be positive, at 5.4% and 6.7% respectively.

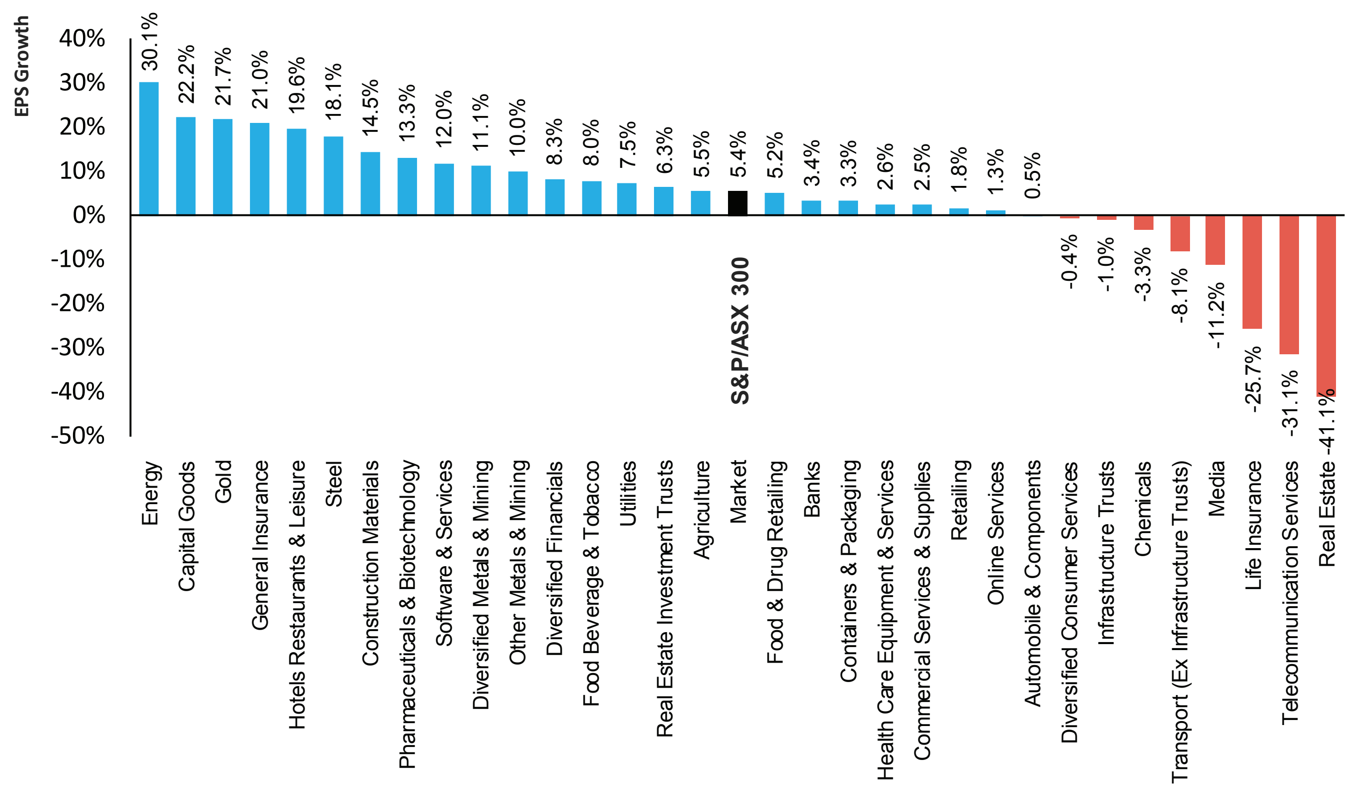
The reporting season for HY19 arrived in the wake of a strong global equity rebound with the Australian market delivering around 10% over January and February 2019, helped by a clear softening in the Fed's stance on rates, the re-opening of the US public service, and growing optimism for a resolution to the US-China trade standoff.

Ausbil maintains a positive GDP growth outlook for Australia in CY19 of 2.7% (against consensus of 2.8%), with 2.0-2.3% for the US (against consensus of 2.4%), and world GDP growth at 3.6% against a consensus of 3.5%. Interest rates are expected to remain low, with the potential for a rate cut in 2019.

The FY19 EPS growth expectation for the S&P/ASX 300, heading into the half-year reporting season, was 5.9% however, after the reporting season, expectation is now 0.5% lower for the market at 5.4% for FY19, as illustrated in Figure 1. Current expectations are for a better FY20 at 6.7%, up 0.5% on pre-reporting season EPS growth.

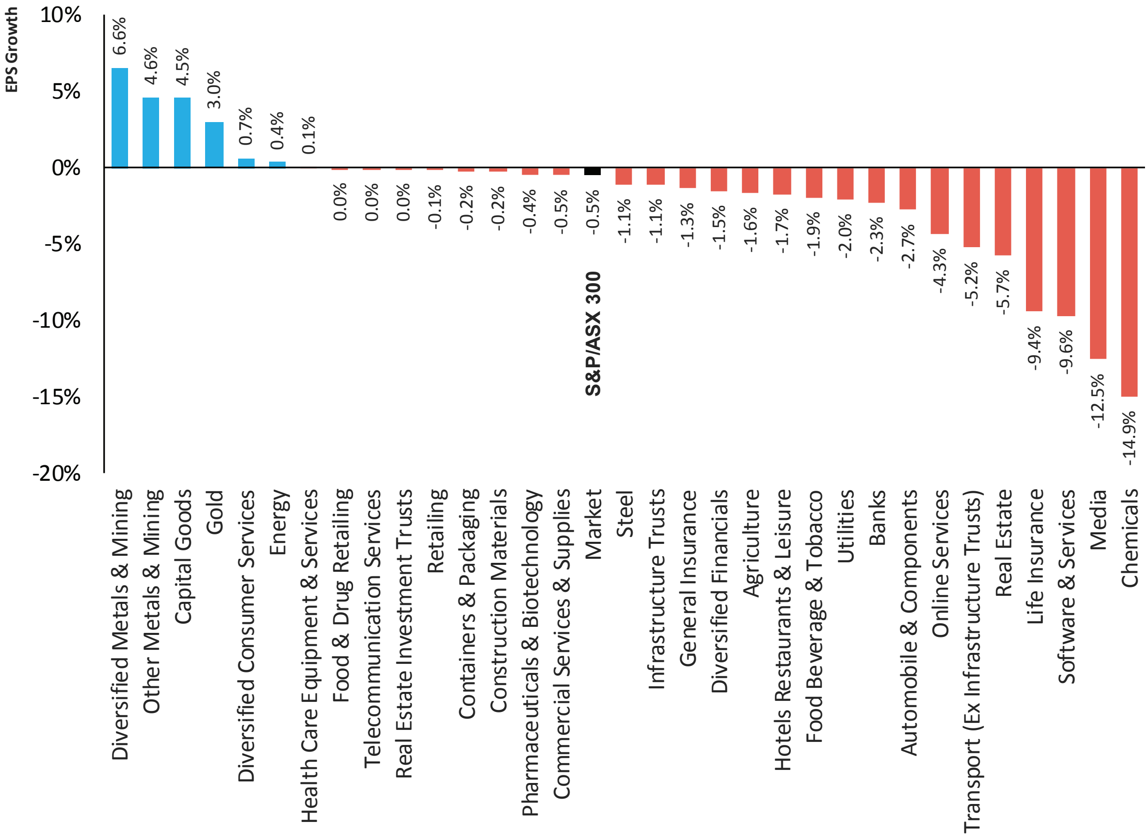
Figure 2 illustrates the change in EPS growth expectations by sector from the start of the half-year reporting season to the end. Of the 32 sectors covered, market expectations for EPS growth were upgraded for 7 sectors, and downgraded for the remaining 25 sectors.

Figure 1: FY19 EPS expectations by sector



Source: Ausbil, Factset

Figure 2: Change in expected EPS growth by sector following reporting season



Source: Ausbil, Factset

EPS growth rerates for FY19 were experienced for Diversified Metals & Mining (+6.7%), Other Metals & Mining (+4.6%), Capital Goods (+4.6%), Diversified Consumer Services (+0.7%), Energy (+0.4%), and Health Care Equipment & Services (+0.1%).

At the other end of earnings, derates of EPS growth included Chemicals (-14.9%), Media (-12.5%), Software & Services (-9.6%), Life Insurance (-9.4%), and Real Estate (-5.7%), among the largest earnings downgrades of the 25.

Record capital management

This reporting season, there have been record levels of capital management, partly as companies were pressed to be able to find positive NPV projects in which to reinvest, and partly in pre-emptive response to the possible loss of franking credit rebates by investors should the mooted Labor policy be introduced. Ausbil will continue to monitor these special dividends and include this in our investment considerations going forward. Figure 3 lists the major announcements covering more than $14 billion in capital flowing back to shareholders in the form of buybacks, special dividends and capital returns.

Figure 3: Record capital management announcements

Company	Type	Amount (A$m)
Rio Tinto	Special dividend	5,556
Brambles	Buyback	2,292
Woolworths	Capital return	1,700
Wesfarmers	Special dividend	1,134
Suncorp	Capital return	600
Brambles	Capital return	417
Telstra	Special dividend	357
Coronado Global Resources	Special dividend	341
Fortescue Metals	Special dividend	339
Qantas	Buyback	305
Caltex Australia	Buyback	260
BlueScope Steel	Buyback	250
Flight Centre	Special dividend	151
South32	Special dividend	119
CSR	Buyback	100
Whitehaven Coal	Special dividend	51
Spark New Zealand	Special dividend	27
Adelaide Brighton Cement	Special dividend	26
Qube Holdings	Special dividend	16
	Total	**14,023**

Equities outlook

With the recent reporting season now behind us, the equity market outlook is one of caution. Markets remain volatile, and a number of major geopolitical risks like trade negotiations and Brexit remain. Ausbil is tilting away from the domestic consumer stocks, particularly the housing and banking sectors.

Ausbil favours quality companies that are generating earnings from offshore, with a growth profile that can avoid the cost pressure in our local market, and which are positioned to benefit from a weaker AUD. For this reason, we prefer an overweight exposure to Resources, amongst other exporting companies with global revenue bases.

With low interest rates, volatility and uncertainty, and a shift towards defensive assets, increasing exposure to longer duration assets such as Health Care may be prudent. Such long duration assets are more economically insensitive, and generate more assured earnings.

Ausbil analyst wrap of key sector (in alphabetical order)

Agriculture

The agricultural sector has been suffering from a long drought that has just recently become a more serious risk with the Bureau of Meteorology increasing its El Niño alert level. There is now risk of further earnings deterioration and pressure on various company balance sheets. This reporting season saw a number of earnings downgrades including Bega Cheese, Costa Group and Inghams. We maintain a watching brief on the drought, and its impact on companies in this sector, as there will be some interesting counter-cyclical opportunities presented.

Automotive

New vehicle sales continue to decline aggressively, which saw earnings downgraded. After-market automotive parts recorded solid profit numbers with no upgrades or downgrades. The after-market sector is reasonably defensive given its target market of older vehicles. Automotive Holdings Group (removed from the ASX200) is the only company within the sector that has exposure to new vehicle sales.

Banks

This reporting season, Banks received the full ire of the Royal Commission as it released its final report in early February 2019. The costs, structural changes, fines and regulatory censure is still to fully play out. This may impact on how Banks are structured and their earnings at the year end.

This round, only the Commonwealth Bank and Bendigo and Adelaide Bank reported HY19 results, with Bank of Queensland issuing an earnings downgrade. ANZ, National Australia Bank and Westpac provided quarterly updates.

A number of key trends emerged. Lending volumes are weakening, and margins are under pressure from strong competition in a relatively low volume growth environment, with challenging funding costs. Markets and trading income were weak due to low activity levels. Cost management and productivity improvements are a key focus, particularly in a low credit growth environment and with ongoing regulatory and compliance cost pressure. Impairment expense remains at, or near, cyclical lows, with relative stability in credit quality exhibited, albeit with early signs of some weakening of past due metrics for some classes of loans. Capital levels remain adequate, to good, across the sector, however proposed NZ regulatory capital changes are an uncertainty.

Building Materials

The correction in housing prices, the fall in lending on residential and construction loans, and the regulatory impact on credit liquidity, has seen a resultant slowdown in residential construction across Australia. This has directly impacted Building Materials company earnings, with Adelaide Brighton downgrading earnings, with the prospect of margin damaging price competition between companies as they negotiate a slower market.

Capital Goods

The Capital Goods sector performed well during the reporting season with a number of earnings beats and strong growth in order books. Outlook for the sector has been strong for those companies exposed to the resources markets, and we are now seeing the earnings flow through from a recovery in capex spending. Companies exposed to the infrastructure space are continuing to see strong revenue growth as the cycle plays out. The big winners from the growth in east coast infrastructure spend have been the rental and equipment providers, compared to the contractors that take on large amounts of design and construction risk.

Communications Services

The Communications Services market is rationalising, though competition, for now, remains elevated – the scale players are gaining share from the smaller providers/re-sellers. The NBN uncertainty remains an overhang across the sector. The Telstra re-setting is running to schedule.

Diversified Financials

In registries, Link Market Services was slightly weaker than expectations, the ASX and Computershare modestly beat expectations, and Iress Australia was in line with expectations. In investment management, companies with the exception of Perpetual, posted solid earnings characterised by good gross inflows. In Insurance, underlying margins for general insurers were all up. The Insurance sector is seen as defensive and is benefitting from this positioning in the current market environment. We continue to monitor the effects of storms, floods and other recent issues and how these play out in the balance sheets of insurers heading into the year end. Among life insurers there were more downgrades, but this was expected from a sector that is facing significant structural change, and is going through fundamental challenges with their business models.

Energy

Growth in the Energy sector is clearly on the agenda, with all larger oil companies progressing significant development programs. Cost reduction continues with the focus on sustainability in lower oil price environments. Refiners were impacted by significantly depressed gasoline crack spreads. In retail petrol, we expect the competitive landscape to escalate.

Health Care

Overall, in Health Care there were more misses than beats. On earnings, there were more downgrades than upgrades. Cochlear earnings showed weakness in the core cochlear implant business. Health Care, however, offers long duration assets with more defensive characteristics that are becoming more sought after by investors in this market.

Hotels, Restaurants & Leisure

Overall, the sector disappointed on earnings with downgrades across the board, except for Corporate Travel and Skycity Entertainment. Earnings quality was reasonable. In gaming, Crown and Star Entertainment delivered much weaker than expected results. Tabcorp Holdings delivered a solid result for lotteries, offset by investment into wagering to gain share. The macro environment is likely to continue to be challenging in terms of consumer spending. In travel, weak consumer spend was evident in domestic leisure travel with the industry recording relatively flat growth.

Infrastructure

Sydney Airport, Transurban and Atlas Arteria largely delivered results in line with expectations. Infrastructure assets have benefitted from high barriers to entry, sustained low interest rates, population growth and GDP growth. They have also seen rerating on the strength and stability of their long-term cashflows.

Media

The Media sector, overall, outperformed, largely driven by Nine Entertainment and Southern Cross Media with reasonable earnings quality. Earnings, however, were largely downgraded. Seven West Media and oOH!media were the worst performers. For the traditional media players, the advertising market remains challenging with companies downgrading their ad market outlook, with further risk to the downside. Revenue share gain is the focus for the TV players, though this is largely driven by ratings performance. Radio remains resilient against a tough macro backdrop.

Metals & Mining

Generally, mining performance was impacted by reduced global growth concerns, clearer signs of China stimulus (sharp improvement in the China credit impulse in January) and major supply disruptions in iron ore. Strong cash returns continue, including healthy ordinary and special dividends, plus buybacks. Capital discipline is holding, but the pivot to growth continues. Cost pressures remain, but have eased with far less focus from management teams compared to six months ago, though the labour market remains tight. ESG and climate change pressures are having effects on strategy and investment decisions. Tailings disclosure and processes are evolving quickly following the Vale Brazil tragedy. In steel, trade wars are impacting on the current and forward outlook. Structural changes in the Chinese scrap market are impacting the global trade of scrap.

Real Estate

The Real Estate sector saw a reasonably stable reporting season as expected. Office markets in Sydney and Melbourne continue to outperform, driven by low vacancy rates, strong net effective rental growth and further cap rate compression.

The industrial market continues to be one of the standouts, with tenant demand and rental growth driven by large e-commerce players. The flow of global institutional capital into industrial assets is also driving further cap rate compression.

Retail markets continue to underperform as retail sales remain subdued and re-leasing spreads deteriorate. This has seen net tangible assets within the sector come under pressure, driven by negative rental growth and cap rate expansion.

Residential markets also remain under pressure with sales rates across the residential developers struggling. Sales rates were down on the previous corresponding period. However, settlements still seem to be healthy, with default rates currently remaining low.

Retailing, Beverages and Consumer Staples

In Retailing, most results were in-line with company guidance and market expectations. In Beverages and Consumer Staples, results overall were disappointing. Treasury Wine Estates' cash flow was weak. Capital management was announced in the Consumer Staples space, notably by Wesfarmers and Woolworths. For the sector, the overall outlook was cautious.

Software & Services

The sector outperformed on earnings upgrades. Appen and Altium outperformed strongly on results with earnings upgrades. WiseTech Global underperformed on earnings downgrades. Earnings quality was reasonable. The cloud or SaaS players continue to perform strongly with ongoing strong demand. Technology innovations such as IOT, digitisation and AI are driving strong growth for these businesses. The outlook remains strong with significant revenue opportunities. Stocks, however, are not cheap given their growth profile.

Transport

The Transport sector is largely linked to the performance of the economy. Whilst the Australian economy is still growing, the slowing rate of growth is having an impact on transport companies like Qantas, Qube and Aurizon. Whilst these companies generated earnings that met with consensus, the coming earnings seasons are subject to Australia's economic growth.

Utilities

Utilities largely achieved earnings in line with consensus this season. This sector includes energy providers like Origin and AGL, and infrastructure like APA Group (pipelines), Spark Infrastructure (power) and AST (electricity transmission), all of which will be impacted differently by energy regulation, a topic that is heating up in the lead up to the elections. The long-term outlook for Utilities is strong, but with politicisation of energy regulation and prices, there could be short-term impacts on earnings.

Our ESG perspective

ESG themes were particularly relevant this reporting season, especially with release of the final report by the Royal Commission on Misconduct in the Banking, Superannuation and Financial Services Industry. The Government Inquiry into the franchise industry impacted a number of listed companies. Various shareholder resolutions on ESG issues and the passing of the Modern Slavery Act by the Australian and NSW governments also found companies looking to improve monitoring and reporting. 2018 witnessed a historically high number of strikes against remuneration reports at AGMs, as shareholders took a particularly hard line on misalignment of remuneration and outcomes. Several companies have now adopted the Taskforce on Climate-related Financial Disclosures (TCFD) reporting framework, which provides better transparency on the risks and opportunities from climate change.

About Ausbil Investment Management

Ausbil Investment Management (Ausbil) is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil manage over $11.6* billion in active Australian and global equity investments. Ausbil is owned by its employees and New York Life Investments (NYLIM), a wholly-owned subsidiary of New York Life Insurance Company. NYLIM has more than US$561* billion in assets under management. NYLIM has a number of boutique affiliates including MacKay Shields, Candriam Investors Group, Private Advisors and GoldPoint Partners.

*as at 28 February 2019.

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