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Reporting Season Wrap

Market Insights

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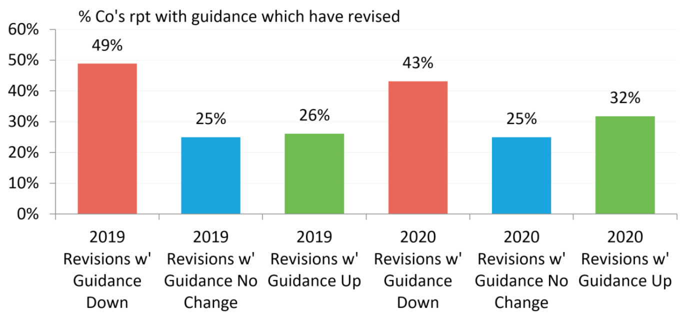
Profit results showed a broadly even split between companies that respectively missed and beat consensus earnings forecasts. Slightly more than half of the results announcements included earnings guidance for the 2019 and 2020 financial years, with downgrades outnumbering upgrades for both periods.

154 companies within the ASX 200 have reported results, with 57% providing guidance. The ratio of down/upgrades is 1.9x in FY19 and 1.4x in FY20



Source: Factset, IBES, Morgan Stanley Research. Note: Down/Up is where concensus EPS has been revised +/-1%

Major themes that emerged from the season were:

Short covering rallies

Several stocks experienced substantial price movements in the immediate period surrounding their results announcements. Earnings surprises were the main driver, although the extent of price swings was significantly greater among stocks that were heavily shorted. This was particularly evident in the information technology and telecommunications sector, where Telstra experienced increased buying interest in response to a rotation out of the resources sector where increased costs and tariff fears dominated.

Capital management

Income-focused investors were well rewarded with substantially higher dividends and several announcements of shareholder-friendly corporate actions. Increased dividends and several stock buyback announcements were reflective of generally enhanced balance sheet strength, as higher cash flows compensated for increased cost pressures.

Margins

Companies with mature business models generally reported slightly increased or stable margins. Expansion rates were significantly greater for earlier stage companies with good operating leverage. Margin reinvestment was a common theme as companies sought to take advantage of attractive business conditions, retaining a preference for internal versus external capital sources.

Corporate activity

This featured prominently across the market. Within the large cap sector, Santos bought Quadrant Energy, Nine Entertainment proposed a merger with Fairfax Media, and TPG Telecom proposed a merger with Vodafone Hutchison Australia.

Within the small cap sector, there was a stark contrast in the motivation underlying various acquisition announcements. Appen, Emeco Holdings, Acrow Formwork and Smartgroup Corporation were among those companies whose acquisition announcements reflected a clear strategic purpose. In contrast, the acquisition initiative announced by BWX showed a greater focus on cost savings.

Bingo Industries announced a capital raising pursuant to its proposed acquisition of fellow recycling and waste management business Dial A Dump Industries.

Offshore earners

Stocks exposed to the Chinese consumer sector, such as The A2 Milk Company and Blackmores outperformed. The infrastructure sector saw good results from Cimic Group, Seven Group and Downer EDI. More broadly, offshore earners are benefiting from an easing in the A$ against a backdrop of generally sustained global economic growth. Moreover, those with a technological advantage are well placed to successfully expand overseas. It is nevertheless becoming more strategically valuable to have an in-country presence in an increasingly protectionist environment. Stocks with high quality US EBIT, such as CSL, Treasury Wine Estates and James Hardie Industries were prominent among the outperformers.

Royal Commission

News flow from the ongoing inquiry continues to weigh on sentiment towards domestic banks and insurers. This has been exacerbated by calls to extend and expand the investigative mandate of the Commission.

Disruption

Companies with disruptive business models, for example WiseTech Global, Afterpay Touch Group, Appen, Nearmap and Audinate Group reported strong results. Moreover, they are extending their respective competitive advantages, having caught their more traditional competitors off guard.

Political upheaval

Political developments that culminated in the change in Prime Minister did not directly impact the corporate sector. Nevertheless, the consequent uncertainty over the longer-term outlook for key economic and social policies, such as imputation credit refunds and negative gearing for housing investment, has increased the level of regulatory risk.

ESG

Staff engagement was one of several key themes during the recent profit reporting season. It is an important consideration for two reasons. First, research shows that the majority of company value comes from intangible factors, of which culture naturally forms a big part. Secondly, staff engagement is linked with productivity and staff turnover rates.

A clear trend that emerged during the season was the continued improvement in occupational health and safety (OH&S).

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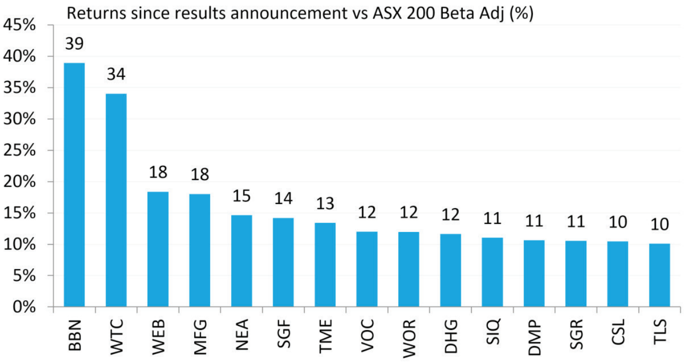
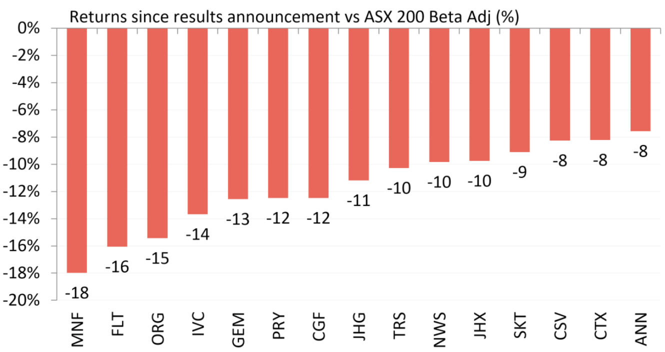
Notable improvers included Ansell, Bega Cheese, Brambles, Fletcher Building, GUD Holdings, Independence Group, Iluka Resources, Mineral Resources, St Barbara, Sims Metal Management, Santos, Whitehaven Coal and AGL Energy.

Stock performance

Top 15 Performers Since Results Announcement



Bottom 15 Performers Since Results Announcement



Source: Factset, Morgan Stanley Research.

Resources (Metals & Mining & Energy)

Earnings results were generally highlighted by:

- Pressure on commodity prices – associated with weakness in the emerging market economies and strength in the US$; and
- Rising labour and energy costs.

The negative earnings impact of higher costs was magnified by fears associated with the prospect of higher tariffs.

Cost factors were particularly evident within the mid- and small-cap sectors. They similarly had an impact on mining services suppliers such as Emeco Holdings, Imdex, Decmil Group and Alliance Aviation. Mount Gibson Iron posted a strong result, buoyed by the strength in demand for high-quality iron ore. Another theme within this area was a renewed willingness to increase spending on capacity and research development. Among the energy stocks Woodside Petroleum and Origin Energy missed earnings expectations. In contrast, Oil Search outperformed expectations, while Santos was prominent among the companies whose consensus earnings expectations were revised upwards.

Health Care

The sector delivered generally strong earnings results. This was largely attributable to the strong performance of offshore earners, notably CSL, Cochlear and ResMed. These companies' operational performance was boosted by the contribution from a weakening in the A$. In contrast, hospital operators Ramsay Health Care and Primary Health Care produced significantly weaker results.

Telecommunication Services

The sector generally delivered earnings disappointments. However, in terms of price performance, it was buoyed by a rotation from growth-oriented stocks to more value-focused stocks. This theme was reinforced by consolidation within the sector, highlighted by the proposed merger between TPG Telecom and Vodafone. Despite earnings misses, several telecom stocks rallied due to shorts being covered. This has lifted the sector's relatively high p/e level even further.

Information Technology

A significant re-rating of the sector's p/e multiple was a highlight of the season. Online classified advertisements providers, such as Carsales.com and Domain Holdings, rallied despite missing earnings forecasts. The market clearly took a favourable view of top line revenue growth, with upward momentum in several of these stocks further boosted by short covering.

Utilities

The reporting season highlighted that these companies are vulnerable to increased regulatory pressure associated with consumer resistance to rising electricity and gas prices.

Retail

JB Hi Fi, Super Retail Group and Nick Scali were among retail stocks that rose strongly on in-line results as they were heavily shorted or had modest earnings prospects leading into the reporting season. Online strategies were a key point of focus for Specialty Fashion, Accent Group, Adairs and Lovisa Holdings. These companies are actively developing online sales strategies and appear increasingly able to deal with the imminent Australian launch of Amazon. Bricks and mortar retailers in 'B' and 'C' grade retail space appear to be gaining the upper hand in rental negotiations with landlords.

Within the small cap sector, retailers generally achieved like-for-like growth despite the headwinds facing the household sector. The importance of organic growth is vital as retailers can no longer rely on store rollouts as the sole driver of earnings and multiple growth. Those with strong online capabilities that have optimised the synergies between their electronic and bricks and mortar operations, such as Adairs, Specialty Fashion, Noni B and Accent Group, were among the top performers. A notable theme among online-focused retailers is their improving ability to analyse data to gain a deeper insight into their customers' behaviour.

Summary of earnings

For the S&P/ASX 300 Index, consensus EPS forecasts are now at +7.6% for the 2019 financial year, and +5.4% for 2020. These translate to price-to-earnings multiples of 15.9x and 15.0x for 2019 and 2020 respectively, and a dividend yield of 4.4%.