Contactus@
ausbil.com.au

ausbil

Ausbil Reporting Season Wrap

Ausbil Investment
Management Limited
ABN 26 076 316 473
AFSL 229722
Level 27
225 George Street
Sydney NSW 2000
GPO Box 2525
Sydney NSW 2001
Phone 61 2 9259 0200
Fax 61 2 9259 0222

Full-Year 2019

Key points

- Overall, the reporting season had mixed results with weak revisions to FY19 EPS growth, downgraded to just +1% from estimates of +9% at the start of the financial year.
- FY20 estimated earnings growth remains high at +8% EPS growth.
- Valuations are towards the upper end of the range, post earnings season, with the market (S&P/ASX 200) trading on a forward PE of 16x for FY20.
- The 30 June reporting season saw full year 2020 market EPS growth expectations derated by -1.6%, from +9.8% to +8.2%.
- Key sectors that were rerated for FY20 included Real Estate, Retailing, Gold, Infrastructure Trusts, and Hotels, Restaurants and Leisure.
- Key sectors that were derated for FY20 included Media, Online Services, Chemicals, Containers and Packaging, and Agriculture.

The reporting season had mixed results with weak revisions to FY19 EPS growth, downgraded to just +1% from estimates of +9% at the start of the financial year. However, FY20 estimated earnings growth remains high at +8% EPS growth, though with the risk of some weakness from geopolitical and trade risks. Valuations are reasonably full, post earnings season, with the market (S&P/ASX 200) trading on a forward PE of 16x for FY20, and the industrials on a PE of 23x for FY20.

Across the market, this reporting season, some weakness was seen in domestic earnings (Adelaide Brighton, Bellamy's, Boral, Costa Group, Inghams, oOh! Media, Seven West Media and Speedcast), in companies exposed to global conditions (Brambles, BlueScope Steel, Crown Resorts, Iluka and Orora), and short-term re-investment for longer term growth (A2 Milk, Afterpay Touch, CSL, ResMed, Seek and WiseTech Global).

On the upside, positive surprises were achieved in dividends and buybacks (ASX, Aurizon, Evolution Mining, Fortescue Metals, Link Administration, Qantas, Rio Tinto and Woolworths), and on good results and upgrades (Afterpay Touch, Beach Energy, CSL, IPH, James Hardie, JB Hi-Fi, Lendlease, Qantas, ResMed and WiseTech Global).

Market context

The reporting season for FY19 arrived in the wake of almost a year of trade war rhetoric and tariff tit-for-tat between the US and China, Brexit concerns, and general uncertainty in markets. The Fed's pivot on rates in early 2019, towards a more dovish approach, spurred markets, but the effect was dampened particularly by trade wars and sub-par global PMI measures.

That said, markets rebounded in the second-half of FY19, following the sharp sell-down of calendar Q4 2018, to deliver an annual return as at 30 June 2019 of 11.42%, as measured by the S&P/ASX 200.

The market entered this reporting season in the heart of a record 28th year of uninterrupted GDP growth with monetary and fiscal policy stimulus recently injected. Australia's GDP is expected to grow by 2.1% in 2019, and recover to its trend pace of around 2.7% in 2020, with US growth expected to slow to 2-2.3% in 2019 from its 2.9% average in 2018, and return to its long-run trend of 2% in 2020. Eurozone growth is expected to slow to 1.3% in 2019, and Japan to slow to 0.9%, both with downside risk.

Following the Fed pivot in early 2019, Australia's official cash rate was dropped by 25 bps in June and again by 25bps in July to a record low of 1%, with the Fed dropping rates by 25 basis points in August, and expectations of further rate cuts to come.

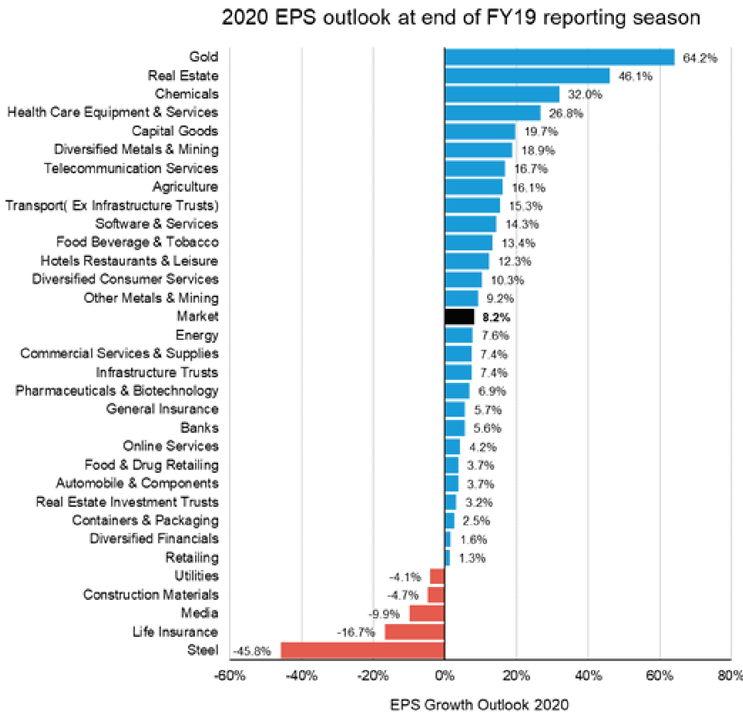
EPS outlook for FY20

Figure 1 illustrates the FY20 EPS outlook across 32 sectors, from highest to lowest growth expectations, with the market itself expected to grow by a healthy 8.2% in FY20, though this is down by a nominal -1.6% from FY20 expectations of 9.8% EPS growth last year.

The market, as represented by the S&P/ASX 300, is on an expected dividend yield for FY20 of 4.3%.

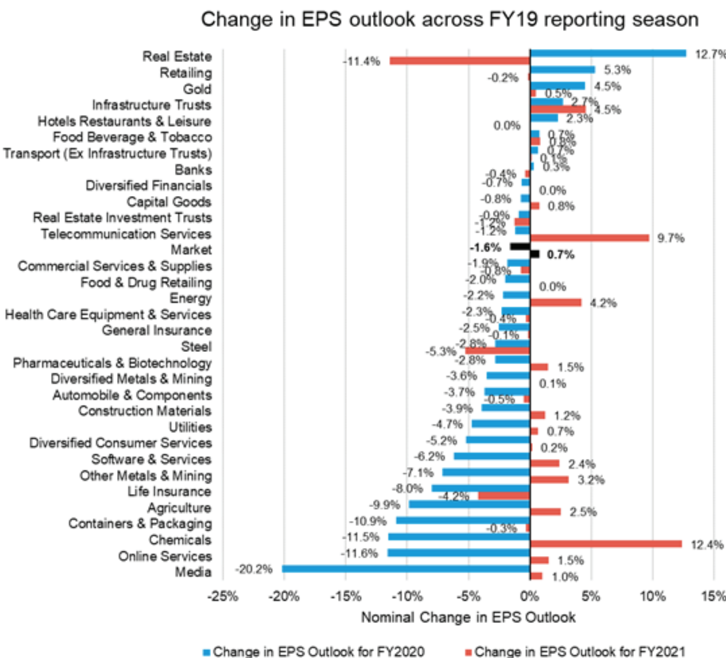
Market uncertainty has seen the gold sector top EPS estimates following the FY19 reporting season, with an EPS growth outlook of 64.2% for FY20, up by +4.5% on expectations prior to FY19 reporting season.

Figure 1: FY20 EPS expectations by sector



Source: Ausbil, Factset

Figure 2 illustrates the change in EPS growth expectations by sector from the start of the full-year reporting season at the end of July 2019 until the end of August 2019. Of the 32 sectors covered, market expectations for EPS growth were upgraded for 8 sectors, and downgraded for the remaining 24 sectors.



Source: Ausbil, Factset

EPS growth rerates for FY20 were experienced for Real Estate (+12.7%), Retailing (+5.3%), Gold (+4.5%), Infrastructure Trusts (+2.7%), and Hotels, Restaurants and Leisure (+2.3%) in nominal terms. At the other end of the spectrum, the largest EPS derates were experienced in Media (-20.2%), Online Services (-11.6%), Chemicals (-11.5%), Containers and Packaging (-10.9%), and Agriculture (-9.9%).

Equities outlook

The equity market outlook remains one of caution, however low interest rates and the expectation that rates will remain low in the foreseeable future has helped buoy markets. Conditions remain volatile, and ongoing geopolitical risks like trade negotiations and Brexit remain a challenge.

In the current environment, 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, Ausbil maintains a preference for exposure to Resources, Software & Services and quality industrials, amongst other exporting companies, with global addressable markets and 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 sectors (alphabetical order)

Ausbil's Equities Analyst Team of nine experienced analysts covers the stocks in the S&P/ASX 200 index. Here is a sector summary of what our analysts have seen in the recent FY19 round of reporting.

Agriculture

The Agriculture sector registered a large number of downgrades and/or earnings misses that were largely anticipated because of the prevailing market issues. China exposed consumer stocks saw large downgrades this reporting period. Moreover, agricultural stocks continue to be impacted by the drought through higher feed costs, higher raw material inputs, and lower grain harvesting volumes. Drought continues to impact the outlook for earnings, as does changes to the Chinese regulatory environment which impacts infant formula sales. This year, headline earnings were distorted by the application of the AASB16 standard.

Automobile & Components

The sector is showing a stable outlook given the nature of the defensive, retail-like characteristics of the sector's companies. Margins are under slight pressure. Stocks met expectations, but have experienced downgrades in their earnings outlook. That said, we expect to see mid to high single digit earnings growth ahead.

Banks

The full year for Banks ends in 30 September each year other than for CBA who reported this round as their books close 30 June. CBA underperformed both Ausbil's and consensus expectations, largely given the recent softening in the loan market, and cost drag from the recent Hayne inquiry. Earnings for the banking sector are expected to be relatively muted as they work through the aftermath of the recent Hayne inquiry, and with more caution amongst consumers.

Building Materials

There is weakness in Building Material stocks as housing activity slows. A higher degree of competition in cement and concrete volumes/price is impacting stocks like Adelaide Brighton and Boral. Uncertainty around trade wars and Brexit has also impacted companies like Reliance Worldwide. The sector exhibited reasonable quality of earnings, however, Australian housing activity will remain weak, and cement and concrete price pressure will weigh on margins. Cost out and restructuring to management margins in a down-cycle remains a key theme for the sector.

Capital Goods

In the Capital Goods sector, tenders and activity levels remain strong, however trade wars and macro uncertainty could weigh on the sector going forward. Revenue growth across the board is evident and margins are flat to slightly higher. Austal had the best performance for the sector, while Worley was the underperformer for the sector.

Commercial Services & Supplies

The consumer environment remains tough, but structural advantages abound (such as death, patents, salary packaging and education). Sector performance was divided, the high PE stocks missed and largely downgraded FY20 earnings, but those which exhibited good organic growth saw the opposite as the market rewarded well run businesses with organic growth.

Brambles noted company specific issues in Canada and Latin America, in conjunction with further cost inflation in North America. The outlook is mixed with uncertainty around global economic growth and the risk of a hard-Brexit. Earnings were distorted from the application of AASB16. The longer-term thematic for waste recovery is attractive, however near-term softness should be expected due to slowing economic conditions. The Australian waste industry is on the cusp of a renaissance of sorts. Softening growth and China National Sword issues will weigh on the sector, but this is likely to create many opportunities for growth, including M&A.

Communication Services

In the Communication Services sector, the telecoms market in Australia and New Zealand is looking rational and pricing is increasing to the benefit of participants, including Telstra, Vocus, Spark and TPM. As a result, the earnings outlook is improving.

Diversified Financials

The Diversified Financials sector was mixed on performance, though earnings were sound, with the thematic more on a stock-by-stock basis, with a number of companies taking advantage of higher prices to raise capital. Credit Corp raised capital for an acquisition, showing good structural momentum in the debt collection sector. IOOF Holdings announced a major customer remediation program following the Royal Commission. Magellan Financial Group also raised capital, with some observers suggesting that value-style investing was set for a recovery.

Energy

Growth in the Energy sector is clearly on the agenda, with all larger oil companies progressing significant development programs. Growth agendas, in some instances, appear set for delays given the impact of joint venture or political issues. Cost reduction continues, with the focus on sustainability in lower oil price environments. In fuel retailing, the competitive landscape continues to escalate. Beach Energy delivered the best result for the space – upgrading earnings guidance and longer term production guidance. Santos similarly delivered a strong result, reduced cost breakeven and continued its balance sheet deleveraging. Oil Search and Woodside Petroleum results highlighted potential issues with growth projects – political and joint venture related. In general, earnings were downgraded during reporting season, however this is also likely to have been impacted by mark-to-market downgrades for the key commodities in oil and LNG prices.

General & Life Insurance

In General & Life Insurance, the life insurance sector continues to wrestle with the economics of its business model, while the general insurance sector wrestles with competition. Earnings were solid with insurers in a good place in terms of the premium rate cycle. QBE has improved and has taken on more defensive attributes compared to the rest of the sector.

Health Care & Pharmaceuticals

In the Health Care & Pharmaceuticals sector results were mixed. Quality of earnings was divergent, with CSL the highest, and Mayne Pharma the lowest. CSL, Sonic Healthcare and ResMed delivered strong results and outlook statements. However, there were poor quality results from Ansell, Ramsay Health Care and Mayne Pharma. Outlook commentary was broadly positive for the sector as it generates earnings growth that is largely uncorrelated to GDP.

Hotels, Restaurants & Leisure

The sector experienced a relatively disappointing FY19 earnings season. Overall, the sector's earnings were downgraded, particularly for Corporate Travel Management, which saw the stock down significantly. Tabcorp Holdings delivered a solid result for lotteries, but again, this was largely offset by investment into the wagering business to gain share. The consumer environment remains challenging, impacting travel and gaming spend. The ongoing trade war is also having an impact on VIP gaming spend. In summary, many downgrades were largely driven by weak consumer spending.

Media

In the Media sector, near-term, the ad market remains challenging, however Ausbil expects it to improve heading into the year-end and next year as advertisers start to spend on brand campaigns. oOh! Media downgraded earnings significantly just before results due to a material softening of outdoor advertising spend in the September quarter. News Corp was the top performer in the sector. Cost and revenue share gain remains the key focus for TV players. Radio remains resilient against a tough macro backdrop, and outdoor should continue to gain share longer term. Ausbil sees a reasonable earnings outlook for the sector.

Metals & Mining

Generally, mining performance was impacted by concerns around reduced global growth, with trade concerns weighing on the outlook for the space. Despite this, many of the company's results benefited from major supply disruptions in iron ore and strong demand for steel-intensive raw materials. Strong cash returns continue, including healthy ordinary and special dividends. Capital discipline is holding, but the pivot to growth continues. Cost pressures remain. 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.

Fortescue Metals delivered a strong result, beating market expectations, benefiting from high prices, reduced grade discounts and paying out significant returns to shareholders as a result. Iluka reported a disappointing result with zircon markets deteriorating materially over the first half of the year, primarily as a result of trade related weakness. We saw surprises, both to the upside and downside on dividends, with limited buybacks in the space

relative to recent history. Capital management on the whole remains significant, with free cash flow generation benefiting from strength in prices, modest capital expenditure programs and limited merger and acquisition activity.

Packaging

In the Packaging sector, high raw material input costs have been a feature over the past year, however this is likely to unwind into FY20. Cost-out, restructuring and right-sizing all businesses has been a key theme throughout the sector. Reporting was distorted from the application of AASB16 and US GAAP reporting (transition). Low organic growth should be expected across sectors which are relatively defensive, however, the bottom line should be assisted by FX, cost-out and restructuring. Packaging companies are increasingly becoming part of the solution to reduce the need for plastic. This comes in the form of R&D and new recyclable products.

Real Estate

Across the Real Estate sector, fund managers are seeing the benefit of the cap rate compression cycle the most, however, retail continues to be challenging. Residential looks to have bottomed as property prices have shown a positive recovery since the election lows. In terms of earnings outlook, industrial and office look strong, retail is weak, and residential is improving. In general, REITs exhibit quality earnings. However, higher performance fees (lower quality due to their variability) were a theme of this reporting season. A number or REITs raised capital prior to the reporting season with Scentre Group announcing a buy-back.

Consumer Staples, Retailing, and Beverages

The consumer environment is showing early signs of recovery with the benefit of tax and interest rate stimulus, though the ongoing trade war is having an impact on some company supply chains. The retailing sector is reporting strong growth into the FY20 year. Treasury Wine Estates reported in line with their guidance with strong cash conversion, a strong result given market doubts. JB Hi-Fi and Super Retail Group reacted strongly to improving consumer trading. Harvey Norman undertook a rights issue and Coca Cola issued a small special dividend. Retailing generally remains under pressure from the shift to online and in the current economic environment.

Software & Services

The Software & Services sector is generating quality earnings, with the longer term earnings outlook remaining solid. The cloud or SaaS players continue to perform strongly due to significant longer-term opportunities in the global market for these services. WiseTech Global performed strongly following results and announcing a robust longer-term growth outlook. The opportunity in the global logistics market remains significant. Appen was sold off despite earnings upgrades due to underperformance from their recent acquisition, Figure Eight, however we see this as a temporary issue. Appen's core business continues to perform in-line. Afterpay Touch significantly outperformed all estimates to post a solid result on the back of significant global customer growth, including in the US. In registry services, Link Administration surprised with an in-line result, and a buy-back announcement. Stocks in the sector are trading on a premium multiple given their strong growth profile.

Transport

The Transport sector generated quality earnings, with Qantas the best performer, demonstrating the ability to offset material cost headwinds and return capital. Aurizon was able to restructure, gearing-up the balance sheet and returning capital to investors. The longer term earnings outlook remains solid. All companies have strong balance sheets and remain in an upgrade cycle. The poor performance of Virgin now suggests the domestic travel market duopoly will remain rational, providing further capacity and pricing tailwinds for Qantas.

Utilities

In the Utilities sector, the earnings outlook remains reasonable. Cash flow across the sector is strong, and is supportive of further capital management. Poor outlook guidance for AGL was a key disappointment, however this was largely explained by a much higher D&A (non-cash) charge. Lower wholesale prices will continue to weigh on earnings going forward. Despite emerging headwinds, AGL's excess liquidity position is being deployed through higher capex, M&A and capital management.

FY19 ESG perspective

ESG is integrated into Ausbil's investment process for all funds and institutional mandates, and Ausbil maintains ESG ratings for all stocks covered by Ausbil's Equities Analyst Team. This is done by Ausbil's in-house ESG Research Team that sits within the investment team, and produces proprietary ESG research. Ausbil's Equities Analyst Team's recommendations and valuation models account for these ESG considerations and scores.

Key observations on ESG from the FY19 reporting season

'Simplification' has been a key ESG theme for FY19. Many companies are increasingly refocusing on their core activities and simpler product offerings. In many cases, this has resulted in lower ESG risk, particularly when companies are exiting operations in areas (geographical or product) subject to high regulatory risk and/or high operational ESG risk. We have seen this with Banks and a number of Diversified Financials following the Royal Commission. We see this as a positive trend for consumers.

ESG disclosure and sustainability reporting quality and quantity have generally improved compared to prior years, in presentation materials, stand-alone sustainability reports and integrated reporting. There are still areas where we would like to see more disclosure though, and also individual companies that need to improve. Through our active engagement program we have notified companies on how they could improve in these areas.

Increasingly, companies are introducing goals on reduced use of plastics and improving recycling targets. Australia has a burgeoning waste (including contaminated waste) management issue now that a number of countries are restricting imports on the back of local political pressure.

We also observed increased use of data analytics to build better customer-focused marketing. This increases demands on data privacy and cyber security risk management.

The fall-out from the Royal Commission continues with a significant remediation burden as well as falls in customer satisfaction and impacts on staff engagement.

ESG scoring snapshot

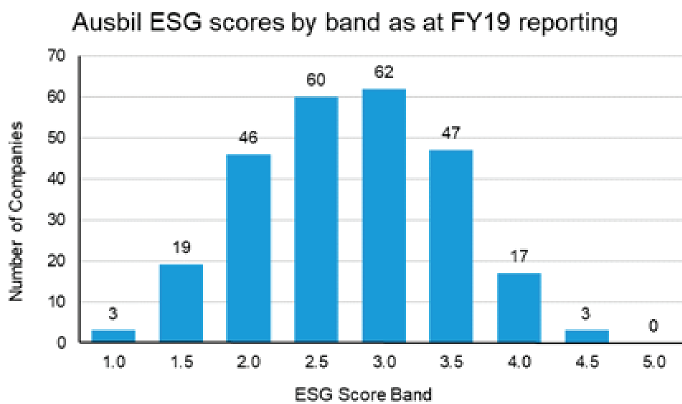
Upgrades: This reporting season, Ausbil upgraded 5 companies on ESG scores based on significant improvements in performance. Furthermore, Ausbil upgraded 8 companies on improvements in momentum and direction in ESG.

Downgrades: ESG scores were downgraded for 2 companies, while 4 companies were downgraded on the basis of momentum and direction.

Description of ESG scores

Ausbil scores companies on overall ESG profiles on a scale from 1 to 5, where 5 is the best and 1 is the worst on an absolute basis, as illustrated in Figure 3. This measure takes into account a wide range of factors that our proprietary ESG research covers.

Figure 3: Current distribution of Ausbil ESG scores



Source: Ausbil

Momentum and direction scores represent which direction a company's ESG profile is developing (positive, negative or neutral scale), as illustrated in Figure 4. We believe momentum in ESG can be a good indicator of operating performance.

Figure 4: The current distribution on ESG momentum/direction

ESG momentum	Number of stocks	% of universe
Positive	67	26%
Neutral	162	63%
Negative	28	11%

Source: Ausbil

For more information on Ausbil's ESG approach please see Ausbil's ESG Policy and Ausbil ESG Annual Report, both available on our website: **www.ausbil.com.au**

About Ausbil Investment Management

Ausbil Investment Management Limited is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management (NYLIM), a wholly-owned subsidiary of New York Life Insurance Company. As at 31 July 2019, Ausbil manage over $12.2 billion in funds under management.

For further information please contact:

Ausbil Investment Management Limited
Level 27
225 George Street
Sydney NSW 2000
GPO Box 2525
Sydney NSW 2001
Phone 61 2 9259 0200

Mark Knight
Head of Distribution
02 9259 0226
0438 307 841
mark.knight@ausbil.com.au

The information contained in this document is given by Ausbil Investment Management Limited (Ausbil) AFSL 229722 and has been prepared for general use only and does not take into account your personal investment objectives, financial situation or particular needs. The information provided by Ausbil has been done so in good faith and has been derived from sources believed to be accurate at the time of compilation. While every care has been taken in preparing this information, except as required by law, Ausbil makes no representation or warranty as to the accuracy or completeness of the information provided in this document, or takes any responsibility for any loss or damage suffered as a result of any omission, inadequacy or inaccuracy. Changes in circumstances after the date of publication may impact on the accuracy of the information. Ausbil accepts no responsibility for investment decisions or any other actions taken by any person on the basis of the information included. Past performance is not a reliable indicator of future performance. Ausbil does not guarantee the performance of any Fund, the repayment of capital or any particular rate of return. The performance of any Fund depends on the performance of its underlying investments which can fall as well as rise and can result in both capital losses and gains.