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FY23 Reporting Season Wrap

Research and Insights

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Ausbil FY23 reporting season wrap and equity market outlook

Key observations

- Overall EPS growth expectations for the market fell further across reporting season by 1.4%, taking the overall consensus EPS growth outlook for FY24 to -3.1% (S&P/ASX 200). However, consensus expects earnings to rebound by +5.2% in FY25.
- This reporting season, earnings showed signs of cost, inflation and interest expense pressures.
- Company outlooks are being impacted by the expectation of a slowing economy, though given the macro context and Australia's excess savings, strong employment market and global demand for our resources, Ausbil expects Australia not to slip into recession.
- There have been some examples of consumer facing businesses feeling the impact of some slowdown in spending, but this was not as widespread as was suggested heading into reporting season.
- In this environment, we believe earnings growth will be harder to find, but we still expect there to be pockets of growth. On aggregate, we see earnings growth for FY24 at a similar level to FY23. There is room for some upward surprise in certain sectors as Australia's economy remains relatively resilient and is operating near full employment.
- We believe dividend yields have peaked, and will normalise across FY24.

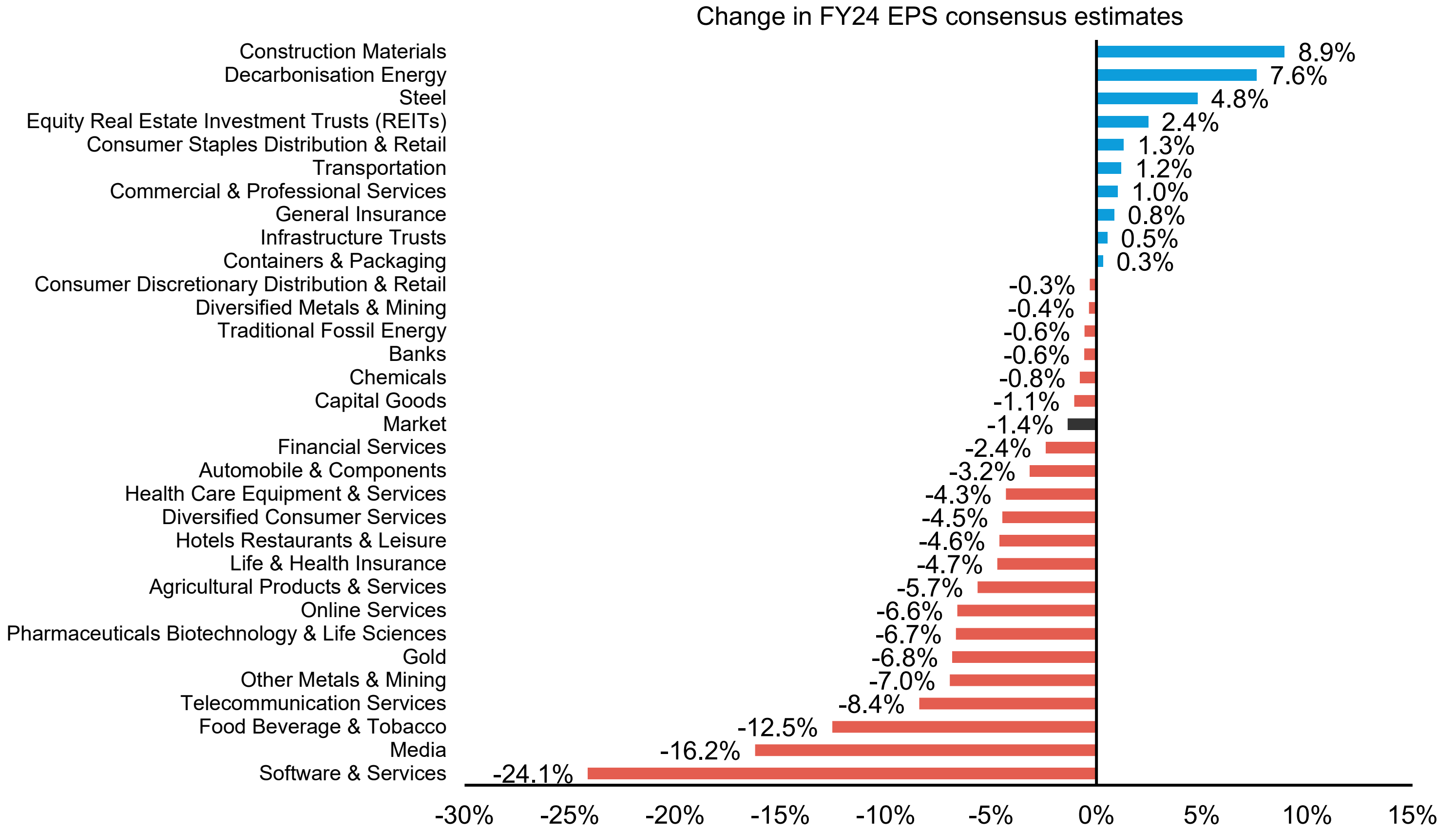
Highlights from reporting season FY23

Earnings. Overall, FY23 delivered an earnings season that saw the market rerate EPS growth expectation down by another 1.4%, taking the overall EPS growth outlook for FY24 to -3.1% (S&P/ASX 200). FY24 guidance is largely softer given the slowing in economic growth and ongoing margin pressure from input cost inflation and higher interest expense. Consensus is expecting EPS growth at market level for the ASX 200 to return to positive in FY25 at +5.2%. At a sector[1] level, Chart 1 illustrates the movement of earnings growth expectations across all sectors.

The Australian economy has been slowing from the 12 rate rises that have moved the RBA cash rate from 0.10% to 4.10% (+400 bps). However, with COVID-induced excess savings and relative full employment, and strong demand for Australian resources, the economy has to date proven to be resilient, and is expected to avoid recession. This is supportive of the earnings outlook.

1. Sector breakdown is based on Ausbil GICS, with amendments to GICS sectors made by Ausbil to help illustrate each sector more functionally.

Chart 1: Nominal shift in FY24 earnings outlook across reporting season



Source: Ausbil, FactSet at 1 September 2023.

Dividends and capital management. This earnings season was slightly disappointing from a dividend perspective. Ausbil believes dividends on Australian equities have peaked and will retreat a little from here until markets have normalised to new levels of interest rates, and the monetary tightening cycle settles. Ausbil projects an average 4.1% yield (before franking) for FY24 from companies in the S&P/ASX 200 Index. This is down from 4.5% in FY23. Companies are cautious this year, losing more cash to interest payments, and holding on to more cash to reduce debt and absorb higher capex commitments. The current average dividend payout ratio of 62% today compares to 72% before COVID-19, with about half of all dividends by dollar weight coming from just eight names. From a sector perspective, the big miners disappointed on dividends relative to expectation, low-quality retailers cut dividends, and the REITs (real estate investment trusts) mostly underperformed.

Ausbil sees dividends under pressure in the next 12-months, with the average dividend payout ratio moving lower as companies have to pay more to finance their capital expenditure, prioritise paying down debt, and react to greater economic uncertainty by returning less cash to shareholders. Ausbil sees this as a short-term adjustment, and not the start of larger dividend cuts or cancellations. As monetary policy stabilises across the next 12-months, the dividend outlook is expected to improve. The main risk to this view is the potential for recession, though Ausbil does not see Australia entering recession given the level of household savings, almost full employment, and the ongoing demand for Australian resources.

Company outlook statements. This reporting season, outlook statements remained cautious given the impact of higher rates and inflation, and the slowing local and global economic environment. Until the market is clear we have reached the terminal cash rate and inflation normalises, companies will be shy about sharing clear measurable outlooks and guidance.

Key ESG observations. This reporting season was issues rich in ESG across the full environmental, social and governance spectrum. Overall, we have seen more disclosure and targets around climate change and net zero commitments, greater inclusion of information on human rights in supply chains and the risk of modern slavery, and TCFD (Taskforce for Climate-related Financial Disclosures).

On the environment, a major development in the TNFD (Taskforce on Nature-Related Financial Disclosures) is likely to be introduced in 2024. The TNFD follows TCFD, which is now a reporting requirement for ASX 200 companies) in seeking to provide a risk management and disclosure framework for organisations to report and act on evolving nature-related risks, with the ultimate aim of supporting a shift in global financial flows away from nature-negative outcomes and toward nature-positive outcomes. This reporting season showed that a number of companies have pro-actively started to measure their nature and biodiversity impact using TNFD principles. While the TNDF in itself is not financially material, it is a good sign of management quality by companies trying to be on the right foot. The benefit of compliance is relatively clear, and laggards are likely be openly targeted by activists and NGOs.

On social issues, the slowing economy, rising rates and significant inflation is placing pressure on individuals (consumers, customers and employees), there has been some focus in engagements on how companies are dealing with the social issues around affordability, rising prices and energy costs in particular. Relationships with traditional owners is another strong theme from engagements, with focus on how companies, especially mining and energy companies, are engaging indigenous communities.

On governance, this reporting season there has been increased inclusion of sustainability-related metrics in executive remuneration, which creates more accountability. This year we will see the outcomes of CPS511, that is the required inclusion of non-financial performance hurdles for financial companies. This reporting season there was an increased focus on cyber security and risk management, which is unsurprising given the multitude of high-profile cyber security breaches in recent years. Most major companies we talked with had or were implementing cyber-security programs. Insurers are actively looking at ways to insure against such risks, with ASX-listed companies perceived to be especially at risks, ironically due to the greater transparency they are compelled to provide. Ausbil has also had diverse discussions with companies on many topics. We have been engaging on the Federal Government's proposed 'Same Job, Same Pay'.

Equity market outlook

Macro context: Returning to more normal settings

There is a distinct normalisation occurring in global monetary policy. Global cash rate policy is presently paused, however there is a risk that new data could see additional rate hikes if inflation remains sticky. In this context, central banks will assess the incoming data and will till move up if needed.

In this context, the yield curve has also been normalising, with the long end rising as the risk of recession is increasingly lowered by the market. Though the curve remains inverted, it is now less inverted than it was in 2022 and early 2023.

Inflation is lower, settling at a higher level relative to central bank targets as component dynamics remain sticky with services (ex-housing), as housing inflation turns lower. While inflation is softening, there is potential upside risk from goods inflation re-accelerating. As inflation is falling, real yields are rising, an important part of our normalisation thesis which is also seeing a widening in credit spreads as pricing moves to more accurately discriminate for risk and duration.

US GDP has been revised higher by Ausbil, driven by a resilient labour market and consumer. Global GDP is on a clearer upward path towards the 3% range, also revised higher to 3.0% in 2023 (from 2.6%), and revised higher to 3.2% in 2024. The global GDP upgrade has been largely driven by the US, with 1.5% in 2023 (up from 1%) and 1.7% expected for 2024 (up from 1.2%).

In this context, with growth still sub-trend, and inflation relatively high, nominal cash rate cuts are still possible if they are needed to offset creeping higher real rates as inflation improves.

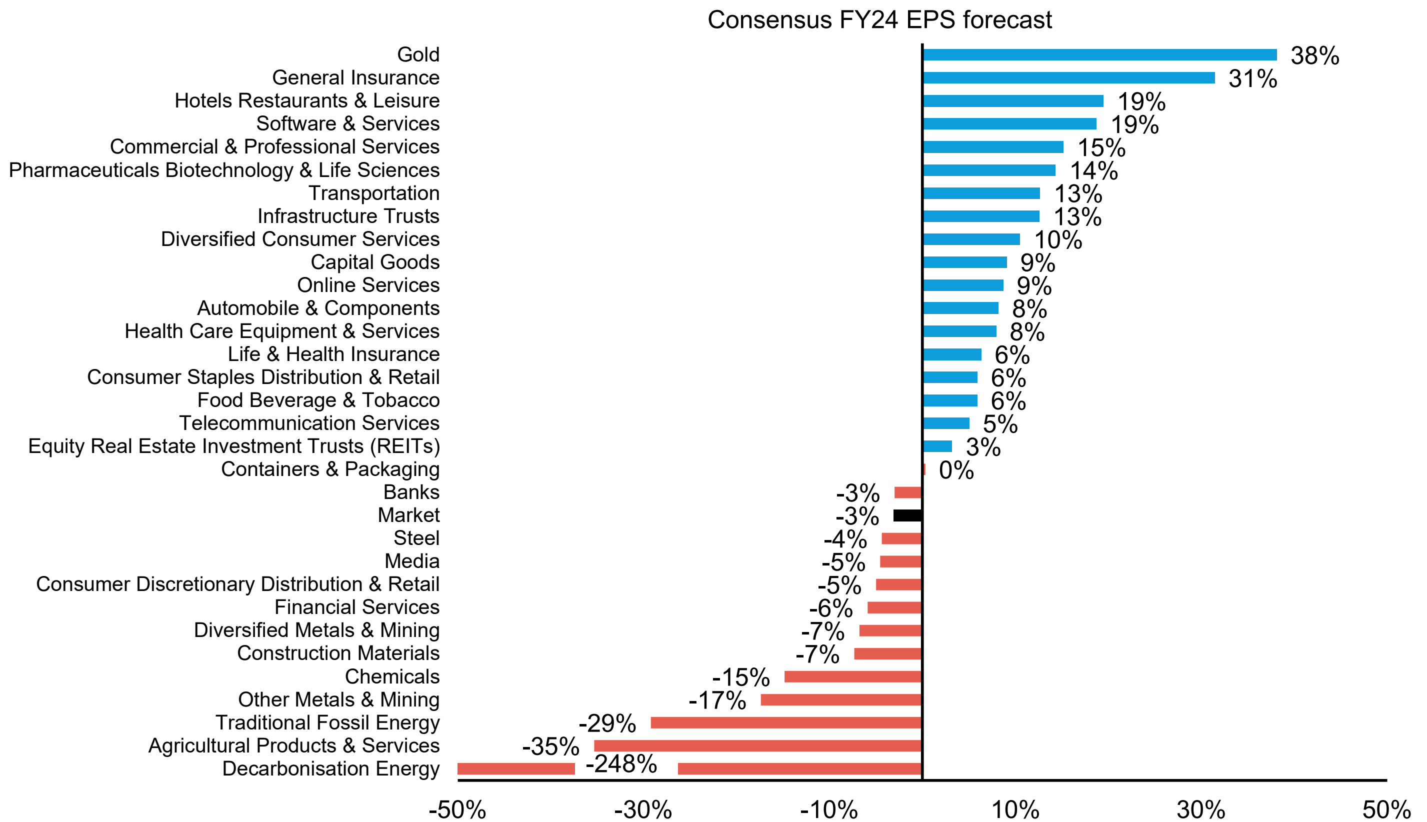
The world economy, and Australia in particular, is underpinned by the long structural dynamics of decarbonisation, and slowing globalization. This, as we have said for some time, translates into a significant rising demand for Australia's commodities, particularly base metals, battery materials, and energy resources.

Australia's GDP remains well supported by continuing labour market resilience, the rundown in excess household savings that is supporting consumers to adjust to the more normal interest rate levels, and population growth through net immigration.

Earnings growth: Will be harder to find in FY24

The domestic earnings growth outlook for FY2024 is likely to be better than consensus forecast for flat growth on an aggregate earnings basis. Chart 2 illustrates the earnings growth outlook for FY24 at the end of reporting season. Ausbil is seeing improvement to the outlook, particularly for banks, resources and energy companies. This is yet to be recognised in the current consensus outlook, but Ausbil's view is that with the normalisation of monetary policy and upward revisions to GDP, consensus will increasingly accept this outlook.

Chart 2: Post-reporting FY24 earnings outlook



Source: Ausbil, FactSet on 1 September 2023.

Higher interest rates will, of course, have an adverse impact on structured and highly leveraged businesses given rising funding costs. Sectors we expect will be impacted by the sustained higher rates will be infrastructure, through the long duration impact on cashflow income streams; and REITs, through rising cap rates, lower occupancy rates, higher funding and high levels of indebtedness relative to adjusted lower NTA.

While rising rates had punished technology names across 2022, the plateauing and normalisation of rates as well as cost-out programs has seen them re-rating in 2023. Ausbil sees technology as a potential earnings rerate, however, as most are long duration growth assets, the impact will be variable. We expect valuations pressures on multiples overall, particularly non-profitable tech stocks. We are selective, and favour tech with underlying sustainable cashflows with strong and growing earnings.

We believe inflation is in a peaking phase in response to the stringent central bank tightening program. The RBA paused in June and July, though with some risk that further small upward adjustments to interest rates could be needed, depending on the evolution of key data. Our view is that we are in the terminal stage of rate rises and we expect short rates to plateau, with some further upward adjustment at the long end.

At this stage, there is no apparent or explicit need to reduce rates, as stabilisation continues, the economy can adjust and operate efficiently at these levels of rates.

The economy is slowing, as intended, and we see economic growth below trend in 2023 and into 2024, but with some resistance that will see Australia avoid recession.

In this environment, we believe earnings growth will be harder to find. Compared to the stellar earnings growth of 22% in FY22 and 30% in FY21 in the pandemic rebound, as we expected, we saw slightly negative growth for FY23, with the earnings growth outlook stabilising into FY24. There is room for some upward surprise in certain sectors as Australia's economy remains relatively resilient and is operating near full employment.

Decarbonisation remains a key driver of Australia's markets, with positive ramifications for the metals and mining, and energy sectors. We remain focused on the key thematics that are driving long-term earnings growth, particularly where imbalances see demand exceeding supply on a fundamental basis for some time. We like critical metals and commodities for the long rotation from fossil fuels to renewables in the great decarbonisation, and the electrification-of-things, with the steady switch from combustion and fossil fuel power to renewable electricity generation. This is a long game which requires

a significant amount of investment. Service companies associated with the cap-ex investment needed for this energy transition are also attractive. With China re-emerging from its intense COVID issues, we see firmness in commodity prices as demand returns across calendar 2023.

There is some noise in resources markets around the China recovery. The expected pickup in real estate has not occurred, but commitment to infrastructure spending remains as a focus to stimulate domestic demand. There are also concerns about the cost pressures in resources and how they are handling this (we are seeing some lower margins but we expect resources to retrace with monetary stabilisation and as the world looks towards growth again beyond the tightening cycle).

Some key observations by sector

Energy

In oil and gas, Australian gas leader, Santos, delivered profit in line with consensus, though EBITDA was 5% below consensus. Karoon Energy, in global oil and gas production, delivered earnings just ahead of consensus, though net profit rose 70% on last year as a result of their recent development program. Woodside Energy delivered a slight miss on earnings though profit was in line. Beach Petroleum, an explorer and producer of oil and natural gas, announced results in-line with consensus but with softer guidance.

In coal, Whitehaven Coal, Australia's largest independent coal operator producing thermal and metallurgical coal achieved a 30% increase in EBITDA, though this was in line with consensus, and a 21% rise in the dividend on high demand for thermal coals given recent energy market ructions.

In uranium, which has rerated since the invasion of Ukraine sparked an energy crisis and is being more actively considered as an alternative energy by policymakers, Paladin delivered positive momentum on their restart of the Langer Heinrich Mine in Namibia, with the project remains on track and on budget for first production in the first quarter of CY24. Boss Energy, the other key player in uranium has also announced positive momentum on the restart of their Honeymoon mine in South Australia, with first production set for the December quarter in 2023. Both companies being junior uranium players are not currently generating income.

Materials

Sector bellwether, BHP, the diversified mining giant in iron ore, petroleum, potash, copper and coal, achieved earnings in line with expectations, though there was a modest miss on the dividend. Cost pressures are coming through, and there was a modest increase to capex. Jansen is on track for 2026 start-up, and BHP continues with their coal divestment program. Increased copper, iron ore and nickel sales volumes, and exchange rates were favourable, profit decreased primarily as a result of the lower prices across major commodities, and the impacts of inflation on the cost base, particularly on labour, diesel and electricity prices.

Fortescue Metals reported a result in line with consensus expectations but announced the loss of their CEO after less than 6 months, and since then followed by a number of other senior executive departures, indicative of some instability in employment across the business. Mineral Resources, with a growing world-class portfolio of mining operations across multiple commodities, including iron ore and lithium, achieved EBITDA in line, with a small beat on NPAT.

South 32, with assets in alumina, aluminium and bauxite, coal, manganese, silver, lead and zinc, achieved results in line at EBITDA level, but 5% below at NPAT. Alumina, a leader in bauxite mining, alumina refining and aluminium smelting, significantly missed on EBITDA by 10%, and on net profit with no dividend called. Alumina faces significant uncertainty due to ongoing delays with mining permits in WA and has been impacted by the rising costs of processing low grade resources.

In battery materials, lithium producer, Allkem, delivered a small beat on earnings but a small miss on NPAT, having negotiated softer lithium prices in the second half of FY23. Regardless, the supply of lithium remains tight with respect to demand, with margins positive through supply chain, and limited inventory. Lynas Rare Earths, a vertically integrated source of rare earths that connects mine to customer, reported results in line on earnings with a small beat on NPAT.

In construction, Boral, the building constructions materials conglomerate controlled by Seven Group Holdings, achieved a good operating result, though the high single digit profit margin remains a focus, and well below target of 'double-digit' margin. By contrast, James Hardie, the other major diversified building materials company delivered a very strong result, exceeding consensus, and with an outlook for double digit earnings growth that is ahead of consensus in FY24. James Hardie's margin is a standout, with the American division posting a record EBIT margin of 31.3%.

In steel, a proxy for the economy, BlueScope Steel delivered results largely in line at EBIT level with a modest miss on NPAT. The dividend was in line and the buyback is ongoing. Guidance for HY24 is solid considering the softer macro environment, demonstrating the strength of BlueScope's diversified business model. Even with rate rises, BlueScope benefited from record COLORBOND steel sales in FY23. BlueScope is well positioned to benefit from favourable trends including reshoring, non-residential demand and ongoing industry consolidation. Sims, the steel recycler posted results marginally ahead of consensus, but a subdued outlook. All metal segments faced challenging market conditions, albeit to varying degrees, with some experiencing more pronounced impacts than others. Near-term subdued global conditions, with weaker prices is likely to see continued weak volume inflows, though at this stage the US market is expected to remain relatively robust.

In the gold sector, Northern Star Resources, Australia's second largest gold producer, delivered earnings marginally ahead of consensus. Evolution Mining, operating gold mines in Australia and Canada, missed on earnings but underlying NPAT was ahead of expectations.

Finally, Iluka Resources, one of the world's largest producers of mineral sands products, missed on earnings expectations, and issued a soft outlook with some disruption impacts due to a synthetic rutile kiln idling.

Industrials

In transportation, Qantas, Australia's largest airline, continued to perform well in post-COVID travel world, this year negotiating the significant change of CEO from Alan Joyce to Vanessa Hudson. Qantas announced FY23 results in-line with consensus and guidance. Regardless of rate rises, travel demand remains strong, and prices remain at the top of the range, though higher fuel costs are detracting. International market capacity is likely to return to pre COVID levels in Q424.

Aurizon missed consensus earnings expectations by 5% and is expected to underperform consensus in FY24 on weak above-rail coal and slowing Australian and global economic growth. While the market has structurally de-rated coal earnings streams, Aurizon has expressed a strategic priority to diversify into non-coal earnings. Qube, Australia's largest integrated provider of import and export logistics services, achieved a slight beat on earnings for FY23. QUB's underlying growth surprised to the upside despite the economic slowdown, which may make it an attractive long-term proposition.

In commercial services and supplies, Downer, one of Australia's largest urban services businesses operating across transport, utilities, facilities management and asset services, announced earnings in-line with consensus and with stronger cash flow, but their outlook commentary was soft. Cleanaway, the vertically integrated waste management company, delivered EBIT in line, but missed on EPS by 3% on interest costs. Cleanaway is a highly geared, capital-intensive business and in a rising interest rate environment, interest cost is putting pressure on earnings.

In capital goods, Seven Group Holdings, with diversified holdings in media, energy and industrial services, such as Boral, WesTrac and Coates, delivered top line growth 7% over consensus but a slight miss on net profit, largely from higher interest and cost inflation (+7%) but miss on NPAT given higher interest expense (-2%). Johns Lyng Group, the diversified insurance builder, delivered a solid FY24 result with revenue and EBITDA slightly ahead of expectations, but NPAT below. Johns Lyng has benefited from recent disasters and is diversified in Australia and the US.

Worley, the oil and gas explorer, reported NPAT in line with consensus, and revenue slightly ahead. Their FY24 outlook statement was positive with revenue growth and better than expected margin guidance. Worley may benefit from the burgeoning investment in the exploration and development across renewable energy sources that comes with the world's shift into the decarbonisation phase.

Consumer Discretionary

Wesfarmers, owner of Bunnings Warehouse - and with diverse business operations in home improvement and outdoor living, apparel and general merchandise, office supplies and in chemicals, energy, fertilisers, and industrial and safety products - delivered a result which was ahead of expectations highlighting the quality of the Wesfarmers franchise. Bunnings margins and top line held up better than expected, and with the restructuring (cost out) program in place, margins may prove to be more resilient than consensus expectations. The group has reaffirmed guidance for lithium spodumene sales in 2H24, which potentially adds commodity risk to their overall profile. JB Hi-Fi delivered a result 3% ahead of estimates, 1H24 trading update ahead for JBH Aus and NZ but softer for TGG.

In the Automobile and Components sector, Bapcorp delivered an in-line result, though with little on outlook. With a weaker consumer, and margin pressure from cost inflation and other external factors such as increasing payroll taxes, Bapcorp are focusing on expanding their business-to-business activity in FY24. GUD Holdings, operating companies in the automotive aftermarket and in water equipment, reported net profit above consensus, and issued positive guidance for FY24. Eagers Automotive, an automotive retail group owning and operating dealerships across Australia, reported their half-year results with top-line growth slightly ahead of consensus, but profit before tax a little under.

Consumer Staples

Woolworths' result was in line with expectations, with food slightly ahead, but BIG W was 15% below expectations. The outlook statement is supportive of continued growth in food while BIG W is expected to remain under pressure. Woolworths reported an improvement in gross margin in the Australian food division, which compares well to Coles where margins declined. With margin pressure, Coles missed expectations on earnings and EPS, with pressure in the supermarkets division driven by higher wages and increased levels of theft, which was up +20% on the prior year. This has been flagged in the industry as a potential risk which is hard to quantify, and likely due to increased pressures on consumers from rising rates. In food and drug retailing, Endeavour Group, licensed hotel operator and owner of Dan Murphy's and BWS, missed on FY23 earnings and warned of potentially weaker retail trading in FY24, though a steady outlook for its hotels.

Health Care

The global leader in blood and plasma products, CSL, announced results in-line with guidance, with a positive outlook for the contribution from acquisition Vifor, continued growth from Seqirus, and strong growth in the core immunoglobin business from record collections, with the business looking to improve margins. ResMed, the developer of medical devices largely for sleep apnoea, delivered a disappointing result with a 5% earnings miss on margin pressure, higher operational expenditure, though US mask sales showed strong growth. While disappointing, the overall outlook for ResMed as a business remains positive. Sonic Healthcare, provider of lab services, pathology and radiology, missed on consensus expectations on profit on weaker margin, with their FY24 guidance implying a further downgrade in earnings. Healius, one of Australia's largest providers of pathology, medical and general practitioner services, and diagnostic imaging, delivered earnings in-line (as guided) but a 14% EPS miss on higher net interest. While operating margins were okay, Healius took a ~$350m goodwill impairment on the pathology business, primarily due to Agilex.

Financials

In Banks, of the majors, only CBA reported as the other majors operate on a September year-end. CBA delivered a solid year end result with NPAT +0.6% pre-provision, +1.2% above consensus expectations, driven by other operating income and slightly lower expenses. CBA is in a strong capital position, and delivered a dividend beat of 18c above consensus with a $1bn buyback. The implied 4Q NIM was ~2.04%, ahead of the ~2.00% 1H24 consensus forecast.

In General Insurance, QBE reported a softer first half result given some unexpected storms in the US late 2022 that impacted early calendar 2023, and a number of redundant business lines that QBE is exiting. Exiting these portfolios will release up to $150m to earnings by 2025 so are positive. Guidance remained unchanged for a strong second half. Suncorp, both an Australian multi-brand insurance (including AAMI, GIO, Vero, Shannons) and banking company, achieved an in-line FY23 result driven by a solid general insurance result, though offset somewhat by weaker performance in New Zealand and the bank. The earnings outlook remains positive.

In Diversified Financials, Computershare delivered results in-line with consensus, but guidance was 5% below consensus for FY24 given the slowing economy and weaker mortgage and business services, and higher expenses. Computershare announced a $750m buyback which will add some support to the stock. Credit Corp, the credit collections company, delivered NPAT in-line with consensus.

Communication Services

The bellwether for Communications Services, Telstra, delivered an EBITDA increase of +9.6%, broadly in line with consensus. Following a record half for the mobile business, EBITDA shows the underlying momentum of what a rational mobile market can deliver and with further price rises expected across the industry this is what effectively underpins the entire Telstra growth profile. Telstra's decision to hold the InfraCo spinoff effectively means no sell-down near term, with earnings growth expected to come from the continued rationality of the mobile market. Overall, the return to a positive industry structure for telecommunications means there is potential for dividend increases in outer years.

Information Technology

In online services, a slowing consumer and housing market has seen muted results across some of the major online services groups. Multinational digital advertising business and property specialist, REA Group, delivered revenue and NPAT in line with consensus. Doman Holdings, the strong second player in the online real estate classifieds market in Australia, missed on EBITDA by 5% and on NPAT by 3% largely on softer revenue due to a slowing in listings as rates have risen and the real estate market has slowed. The outlook is expected to track the strength of listings over the coming year. Also in online services, NextDC delivered an earnings number around 6% below consensus, however, the company has been building its contracts base overall contracted MW billing of 77.7MW to expand by another 67.7MW contract wins that will flow through earnings in the coming years.

Digital recruitment marketplace, Seek, reported a slight miss to consensus for FY23 and issued soft guidance for FY24, noting that the start of FY24 was uncertain with economists forecasting lower economic activity in most markets in which they operate. Carsales reported results in-line with consensus and a FY24 outlook for "good" growth in pro-forma earnings, consistent with consensus estimates, though net debt came in higher than consensus expectations following the acquisition of Trader Interactive.

Utilities

APA Group, which owns and operates gas transmission and distribution assets across Australia, delivered a disappointing earnings number just below consensus, though the top line benefited from inflation-linkage with 5% revenue growth coming from tariff escalation, a benefit of infrastructure. However, APA is in the process of acquiring Alinta's Pilbara assets and raised $750m to fund the transaction that appears to be on an expensive multiple.

AGL, an integrated renewable energy company which engages in the provision of natural gas distribution, announced results in-line with pre-guidance, and reaffirmed their FY24 guidance. AGL is undergoing a transformation from a coal-based heavily carbonised energy utility towards a decarbonised renewable energy player, and is becoming a bellwether for the industry overall on how utilities are tracking towards net zero targets.

Real Estate

Real estate leader, Goodman Group which owns, develops and manages real estate, including warehouses, large scale logistics facilities, business parks and offices, globally, delivered FY23 earnings in line with consensus, but slightly ahead of previous guidance. For FY24, Goodman remains well positioned to deliver mid-teens EPS growth on development earnings; significant data centre opportunities; and the ongoing shift to on-balance sheet development. Charter Hall, also in logistics and commercial property, delivered anFY23 result in line. In a year that is expected to be more challenging for real estate, it is hard to see a year of multiple upgrades given negligible performance fees, however CHC expects acquisitions to equal divestments and asset value movements remain skewed to the downside.

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