

# Costs, cash flow and concerted effort ensured corporate survival

The Australian Financial Review | 09 Sep 2009 | Page: 8 | Supplement

AFR: Has the reporting season been as good as many commentators suggest or is it simply a product of low expectations? Has it confirmed that earnings per share growth has bottomed?

Ian Harding: The profit season was pleasingly 2 to 3 percentage points above expectations despite the dire backdrop of the global financial crisis (GFC). Industrial company profits also outperformed resource companies. Yes, expectations had been wound back but Australia remarkably decoupled from the US economy for the first time in nearly 40 years and delivered a resilient outcome. Earnings per share growth appears to have bottomed and median company 2010 year projections are either stable or up slightly. This is followed by a strong rebound in 2011 due to operating earnings leverage on improving sales, a sharp decline in bad debts for the major banks and a forecast recovery in average commodity prices boosting resource companies.

Paul Taylor: It was a good reporting season. There were significantly more upgrades than downgrades and overall the market saw earnings upgrades to this year and next.

Importantly, the upgrades came from both better cost control as well as better revenues. In addition, cash flows were also generally good, indicating a stronger focus on working capital management. While this was partly a reflection of lower expectations, it was genuinely better market conditions as well as relatively good management of businesses through a slowing period. While market earnings declined in the financial year to June 2009 we would expect relatively flat to slightly down earnings in FY10 with a strong recovery in earnings for FY11.

Simon Rutherford: The reporting season was better than market expectations. Yes, it is true expectations were lowered both by company management and by relentless broking analyst downgrades, but companies really got cracking on cutting significant costs and focusing on cash collection in the second half of the year. The February reporting season had been quite poor; there were a number of companies with materially weakened balance sheets and significantly downgraded earnings forecasts. In contrast, over August the market was clearly buoyed by the lack of negative surprises and solid cash-flow results. The industrials sector was the main surprise and garnered most of the EPS upgrades, which translated into strong share price performances. Resources were flat over the period with no real major surprises. We believe we are at the beginning of a new earnings upgrade cycle with analysts upgrading forecasts for FY10 earnings by about 5 per cent.

Crispin Murray: In February, many companies had been caught out by the rapid deterioration in business conditions. What we have seen in August is a concerted response to those weak trading conditions, first in the form of lower costs and better cash-flow management. Second, we have heard that those underlying business conditions, while still soft, have stabilised and, in some cases, begun to improve. So companies are now in a position to measure the problems they face and have had the time to devise a plan to address them, this is why

the market has reacted positively.

Graham Harman: The good news was not that there was much in the way of upside in the results, but that the downside was kept within reasonable bounds. Major cyclical names with global exposure such as Rio Tinto, Qantas and Brambles have ridden out the storm, and that has been good enough to cheer the market. Earnings quality has also been good in reporting season, with cash flows generally strong. However, downward earnings momentum was still accelerating into the June year-end, and analyst forecasts of positive profit growth for fiscal 2010 will need an abrupt swing in earnings from down to up if they are to be met. EPS growth has almost certainly bottomed but the bounce will need to be hard and fast to avoid slippage to the first-half numbers 2009-10.

AFR: Margins were bolstered by many companies cutting costs. Which were the standouts from this perspective? Does more need to be done in some companies to survive the economic downturn?

Harding: Standout companies included James Hardie reporting expanding margins and a profit at well above expectations despite operating in the eye of the storm (US housing). Harvey Norman had been pressured on margins for nearly six months yet posted a surprise profit result to the upside as most retailers had directly benefited from the federal government stimulus package. Online businesses of Seek, Wotif, Realestate and Carsales (IPO) demonstrated excellent results in the face of the downturn as consumers migrated to their value-for-money offering. The near-death experience from the financial crisis forced companies into an immediate efficiency drive highlighted by aggressive inventory management. It also showed up in economic statistics as a material drop in hours worked rather than a higher unemployment rate. Corporate survival has been largely secured with upside operating earnings leverage now greater than before the downturn due to these efficiencies.

Taylor: There was generally good cost control in the results. But to me this was only part of the story of the reporting season. It was actually the combination of good cost control, better revenues and a focus on working capital that drove good cash flows and a generally better reporting season. From a sector perspective, the standout results were in the retail and industrial sectors, as these more often combined all three elements of good cost control, better revenue growth and strong cash flows.

From an individual stock perspective the standout results were companies such as Seek, JB Hi-Fi, Domino's Pizza, Wesfarmers, Harvey Norman, Woolworths, Commonwealth Bank and AMP.

The other issue on cost control is really concerning operating leverage which is what will really drive improving margins. But we won't see this operating leverage start to drive strong margin improvement until there is a resumption of revenue growth. This is why there should be a strong earnings recovery in FY11.

Rutherford:

Some of the companies that delivered standout margin performances from a strong focus on costs were BHP, Computershare, CBA, Leighton, ERA, Seek, Boral, ResMed, WorleyParsons and James Hardie. Although margins for FY09 were pretty low by historical standards, with the second half 2009 operating margins getting as low as 1990-91 levels, good cost control did stop steeper declines. Therefore, companies are in good shape to expand margins in the economic upturn.

Murray: While there was some cost-cutting, we don't believe this was the defining feature of the results season. Companies that were most exposed to the global downturn made significant cutbacks, such as the steel companies and parts of the finance sector. However, many companies held off on redundancies and focused more on reducing hours and enforcing leave. This was a recognition that after a number of years of very tight labour markets, companies are mindful of their longer-term requirements and the difficulty and cost of re-hiring. Given the better than expected performance of the domestic economy this strategy looks to be correct and explains why unemployment has not risen as much as feared. The volatility of business conditions means we are likely to see a continuation of a conservative approach to cost control, this could provide a good platform for operating leverage if the economy starts to recover.

Harman: We estimate that cost growth overall was still running at 6 per cent or 7 per cent up in FY09, although there were declines in selected sectors such as resources, energy and transport. Cost-cutting gathered pace towards the end of the financial year, but came too late to help the results overall and was not, in our view, a big feature of reporting season. A number of companies have also been hoarding labour - probably correctly given the growing signs of recovery. Revenues were fairly flat for the year, and with earnings down more than 20 per cent for the market as a whole, this implies that margins were being squeezed for 2009. That all turns around for 2010, with costs still sticky, but now sticky on the downside and with revenue growth likely to gather strength. Earnings leverage to any resurgence in sales growth will be high in sectors such as building materials, steel, media and transport.

AFR: What did the change in dividend payout strategies say about how companies are managing capital? Do you expect further equity raisings and, if so, will they still be driven by balance sheet repair or will the motivations change?

Harding: Companies preferred instant certainty this year and tapped shareholders for fresh capital, despite the heavy dilution, rather than risk the slow capital build of restricting payouts. Once the market rally began, there was an understandable zealous move to prudently de-risk balance sheets in the face of a great unknown. Company gearing levels are now conservative with even excess capital, particularly in banking, should a return to normal economic activity occur more quickly. There may be further capital raisings but probably from the second tier companies. Rising confidence could result in more merger and acquisition-driven capital events similar to the well supported Amcor purchase of the Alcoa packaging assets.

Taylor: I would describe the trends in dividend payout policy as sensible. Companies that had stretched balance sheets or were potentially paying out unsustainable dividends either cancelled their dividends or reduced their payout ratios to more sustainable levels.

While this can be painful for investors relying on the dividends, it is a more responsible approach to capital management for companies with stretched balance sheets and unsustainable dividend payout ratios.

Companies that were able to achieve good profit and cash-flow growth and did not have to repair their balance sheet responded with strong dividend growth. This included companies such as Wesfarmers, Woolworths, JB Hi-Fi and Dominos Pizza. They delivered growth in dividends reflecting their strong cash flows; also signalling a potentially good outlook. There could be more equity raisings but we believe we are through the vast majority of those required. Sectors such as infrastructure, utilities and property, and small cap stocks may require more capital. We are also potentially entering a period of increased M&A activity and could see more equity raisings by

large cap companies for acquisition opportunities.

Rutherford: There were some positive dividend surprises from companies such as Woodside, CSL, Centennial, Newcrest and Bradken, but generally most companies chose to adopt conservative dividend policies to strengthen their balance sheets for the future. Many companies managed their working capital much better in the second half of 2009, cut dividend payments, raised fresh equity and cut costs. The market's gearing for FY10 now stands at about 35 per cent, which compares to the unsustainably high levels of 58 per cent in early 2008. We don't expect many more capital raisings as they are pretty well complete now and expect future raisings to be motivated by growth considerations

Murray: One of the key features of reporting season was the much improved state of corporate balance sheets. Much of this is due to the more than \$65 billion of equity raisings since the Lehman collapse, but we have also seen a renewed focus on cash flow. This manifests itself in much tighter working capital management and a greater value placed on retained earnings. Balance sheets will continue to strengthen in the next six months as companies react to higher interest rates and look to reduce their reliance on banks. We do expect to see more equity raisings, albeit not at the same pace and scale; they are more likely to be accessing capital for acquisitions of bolt-on businesses and assets that get shaken out of other companies as they refocus on core businesses.

Harman: Dividends came in better, on average, than Citi analysts were forecasting, but not by a great deal. There was significant variation in the dividend outcome across companies; for every two companies that cut their dividend in 2009, there was one company that managed an increase. Payout ratios fell for just over half the market, as companies scrambled for cash. If anything, corporate Australia is now overcapitalised, with the big swing from debt to equity funding in 2009 driven more by the dysfunctionality of credit markets than by balance sheet inadequacies.

AFR: Which sectors now represent good value and what are your preferred stock holdings?

Harding: Relief that the bad debt cycle has peaked should see progressive and persistent upgrades to bank stock earnings. Financials led the market down so it stands to reason that they will continue to bounce back. Discretionary sectors have already run hard, especially the retailers, though traditional media is lagging because of the online threat. I like the message given when media tycoons are competing to buy assets rather than sell assets.

Australia also has an extraordinary energy theme with the high number of announced capital intensive liquid natural gas projects - suppliers of engineering services to this capex surge should do well.

National Australia Bank should continue to recover well as will Macquarie Group.

The cyclical stocks probably have some further legs but they are more a function of global growth forecasts. The global economic recovery ( to date statistically looks like a V but feels like a U.

Taylor: We believe the Australian stockmarket is in a recovery phase and the sectors that tend to do best in this environment are sectors such as retail, media, housing and diversified financials.

These were also some of the sectors that were hit hardest in the downturn and still represent some of the best value as their earnings recover the strongest coming out of the downturn.

Our largest holdings are companies like Seek, Oil Search and Wesfarmers; but these are for very stock-specific reasons.

Rutherford: Some of the sectors that we think represent good value for the next 12 months include transport, media, telecommunications, energy and metals and mining.

Our preferred stock holdings in these sectors include Asciano and Brambles in transport, News Corp and Seek in media, Telstra in telcos, Oil Search and Origin Energy in energy, and Rio Tinto, Equinox and Western Areas in metals and mining.

Murray: The immediate economic recovery theme has largely played out in the near term. The risk of a strong move higher in interest rates in Australia will keep a lid on the building and discretionary retail sectors. We see value in the energy sector, particularly in the LNG-exposed stocks; Oil Search's PNG project is progressing well and this is not reflected in its valuation. Santos has done a good job in creating optionality in its portfolio across a number of projects.

Underlying this sector opportunity is the ongoing strength of the Chinese economy with the knock-on effects to Asian energy demand, which will remain firm for a number of years.

At a stock level we believe Asciano looks good value. The company has fixed its balance sheet, it is in the process of appointing a very strong board and the underlying business is high quality which will benefit from the recovery in Australia.

Harman: There is still value to be squeezed out of the banks, which still offer franked dividend yields well ahead of the official cash rate. We have buy ratings on all four majors, Westpac, Australia and New Zealand Banking Group, Commonwealth Bank of Australia and National Australia Bank. Quality growth names in healthcare are also appealing, with good value in names such as Ramsay Health Care and Sonic Healthcare.

Looking ahead, upside from positive operating leverage will increasingly be a driver. The market has already run hard, but we still see opportunities in more cyclical plays such as Amcor, Downer EDI and Fairfax.

AFR: Can the equity market, which has gained more than 40 per cent since March 6, continue to rally over the coming months? What is a realistic price target for the S&P/ASX 200 Index at the end of the calendar year?

Harding: Some healthy consolidation is overdue as investors have become a bit too confident after the strong gains since March. Talk of an early interest rate rise should not spook investors but rather confirm the strength of the local economy. We may see some sector rotation back into franchise-type stocks as the global beta trade eventually fades. That said, valuation models indicate price-earnings multiples have now returned to normal but on depressed earnings, suggesting there is further market upside on improved earnings visibility. A classic "buy the dips" strategy may be appropriate as global conditions could wax and wane because residual problems still persist.

Taylor: We have a positive outlook on the Australian stockmarket for the next one to two years. The recent market decline was the second worst in Australia's history, only surpassed by the decline of the 1970s. If previous cycles are any guide there is still a significant amount of stock price upside left in the recovery. Market valuations still look attractive and should normalise over the next year or two.

More importantly, the fundamental drivers of the strong performance of the Australian market over the long term, like population growth, excellent natural resource base, high dividends and good corporate governance, we believe, are still very much in place for the next decade.

It is also important to note that even if the Australian stockmarket looks great value it doesn't mean every individual stock will perform well. Individual stock selection, as always, is critical.

Rutherford: A target for the S&P/ASX 200 Index by calendar year end is tough to forecast over such a short time frame, but we think 5000 by June 2010 is a reasonable expectation. The market price-earnings is currently trading around 16 times FY10, but this is on depressed earnings, so the market is focused on earnings leverage potential in FY11 earnings as margins return to more normal levels. In the near term, we are concerned the rally into risk assets and equities, plus the S&P 500 US rally may have run too hard for the time being, so some rotation back into defensive sectors and gold may be inevitable. This would see investors taking profits in Australia in the near future. Longer term, the trends from the reporting season combined with improving macro data heading into Q4 2009 suggest the market will trade higher over the next 12 months.

Murray: The market has a strong tailwind from the combined effects of earnings revisions and liquidity creating significant price momentum, this is likely to keep the market well supported for the rest of the year. There are emerging issues that will check the rally, particularly next year. First, domestic interest rates are heading higher, and second, the currency is likely to move up. Both of these have an impact on earnings. In addition, there is still a lot of uncertainty over the global economic outlook. The developed economies are likely to have insipid growth as fiscal deficits are dealt with. While China, which is a critical growth driver for Australia, may check its own growth if inflationary pressures start to build. These uncertain factors represent key drivers for the domestic equity market.

Harman: We started out 2009 with a 4500 target on the S&P/ASX 200 and see no reason to change from here. With earnings falling sharply into midyear, the rise thus far has been fully accounted for, and more than fully accounted for, by rises in price-earnings ratios in conjunction with improving sentiment and supportive liquidity conditions. The bull market is now in transition from being valuation and sentiment driven, to being earnings driven and that entails a speed-limit on how the current rally plays out in short term. Ongoing profit growth should see a healthy market through 2010.