



PENDAL

September 2018

Reporting season



Wrap & Outlook

Reporting season was itself unsurprising, yet comes at a time of notable distortions and material disruption in the Australian equity market. The results in aggregate indicate corporate Australia is on a reasonable footing, although there is significant divergence in different market segments when looking at the results a little deeper. In our latest Reporting Season Wrap, Pendal's Head of Equities, Crispin Murray, provides a review of the key themes emanating from company results and reaffirms our view that the current environment favours active management and relies on company-level insight to generate attractive returns and avoid the pitfalls.

Very few genuine surprises emerged in August – not that you would know it from the volatile price action which often took place on the day of a company's result. The disproportionate scale of price reactions to often small beats and misses was a key feature of the season and reflects, in our view, the increasing role of systematic, algorithm-driven investment strategies in the market. The large swings in performance left many investors scratching their heads; this phenomenon is yet another factor of which investors must be mindful in an evolving and, in some respects, unusual market.

Nevertheless, once the dust settled, the vista that remained was one of a reasonable outlook for corporate Australia, one which supports our expectation of mid-to-high single digit returns for the market over the next 12 months or so. And there are plenty of opportunities to generate stock-based outperformance on top of this return given that some of the trends confirmed by the reporting season – such as rising costs and the increasing role of government intervention – require a skilful response from management. We are in an environment of heightened stock performance dispersion within industries, driven by the varying ability of companies to respond to challenges. Company level insight and a view on management have never been more important.



Crispin Murray
Head of Equities

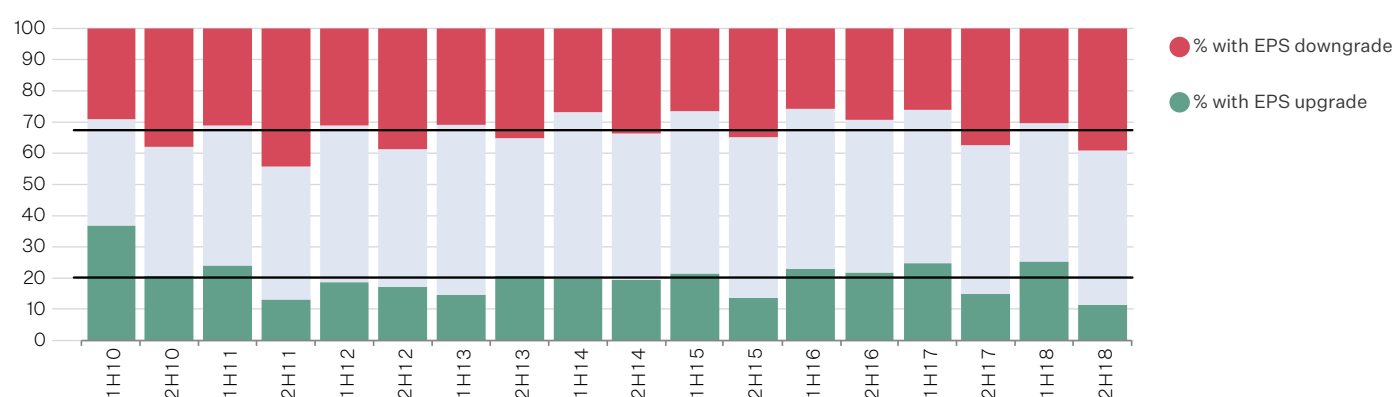
Five observations from the reporting season

1

Limited surprises on reporting season and little aggregate shift in expectations

At a superficial level, there were more downgrades to one-year forward earnings-per-share expectations than usual (see Figure 1). However, the aggregate scale of these downgrades was quite small, while the companies which were broadly unchanged (meaning expectations moved less than 2% either way) were actually marginally better in aggregate. The net result was very little movement in consensus expectations for FY19, which sit at around 5% for the market (ex-Resources).

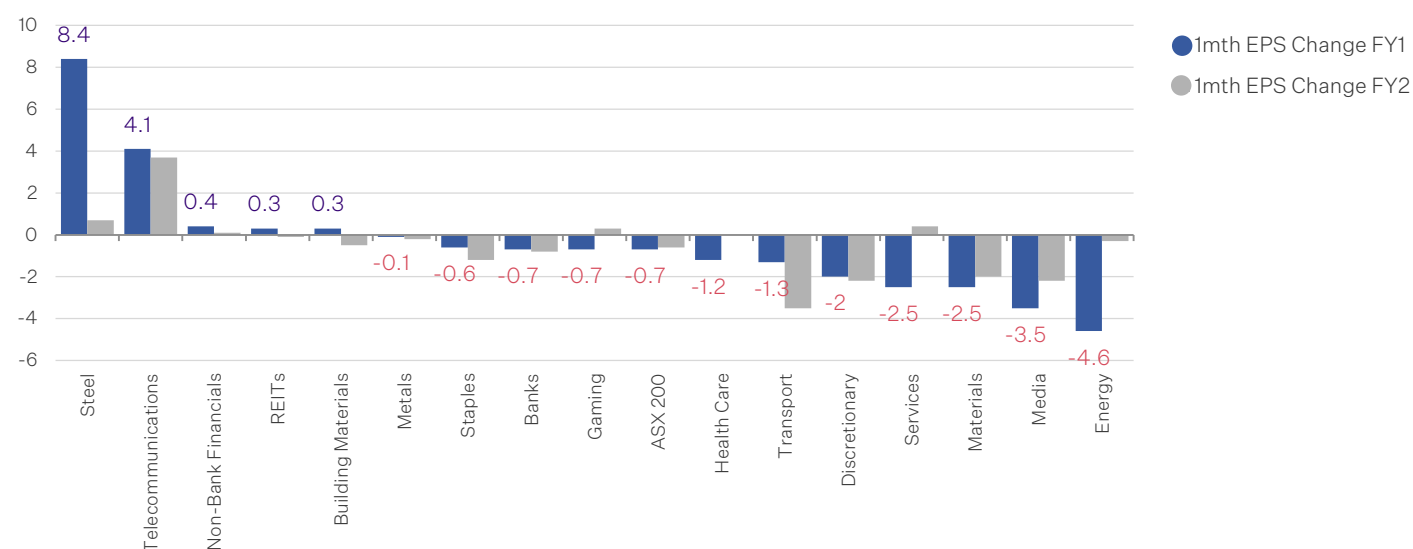
Figure 1: Stocks categorised by 1 year forward consensus earnings change



Source: Goldman Sachs, Factset

The lack of any substantial change in view fed through to a sector level (Figure 2). In those very few sectors where there was a material change, it was largely driven by a stock-specific development and is expected to be short term. For example, Bluescope Steel's (BSL) elevated steel margins in both Asia and the US drove positive revisions for the next 12 months; however, these are expected to normalise in the following year. On the other hand, the negative revisions in energy reflect the one-off downgrade as a result of an accounting change for Origin Energy (ORG) rather than what is a broadly supportive environment for the sector as a whole.

Figure 2: EPS revisions by sector



Source: Goldman Sachs, Factset

Five observations from the reporting season

2

Tailwind of cost reductions and falling interest cost coming to an end

While revisions were generally muted, some of the marginal negative revisions reflect a trend of rising input costs, be they from energy, labour, commodities, plastic or freight charges in the US. At the same time, interest costs have begun to rise from very low levels. Investors have benefited from several years of the twin tailwinds of revenue growth and low costs, with the operating leverage that ensured driving good profit growth. While revenue growth remains consistent – in aggregate – the return of cost growth has begun to drag on profitability. This will increasingly act as a point of differentiation between companies, as some demonstrate a better ability to manage a return to cost inflation than others.



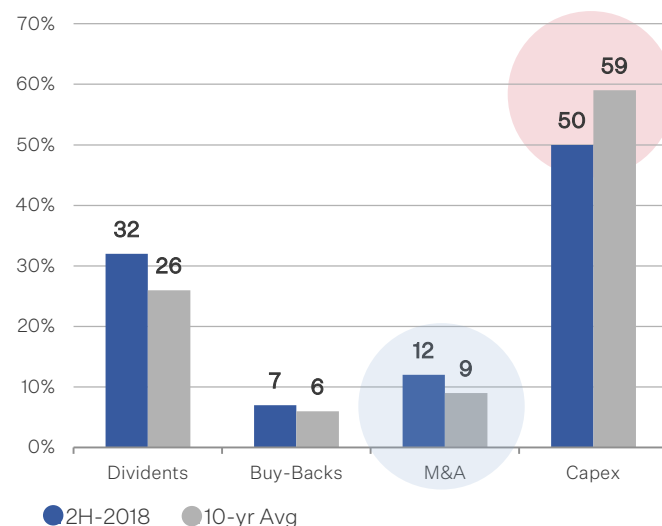
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Cash flow remains strong and capital discipline high

While the increase in costs has crimped cash flow at the margin, in absolute terms it remains healthy and crucially, companies are remaining disciplined in how it is allocated. Hard lessons learned in recent years have seen many companies invest in a more judicious manner than has previously been the case. And where companies have not been able to find an adequate return, they have responded to shareholder demands for capital to be returned via dividends and buybacks.

We have seen a tick-up in merger and acquisition (M&A) activity in recent months, with Amcor's (AMC) bid for US-listed Bemis and Nine Entertainment's (NEC) tilt at Fairfax Media (FXJ) providing good examples. Nevertheless, total return to shareholders remains above its long-term average, while capital expenditure remains below it. This return of capital continues to provide a measure of support for equity markets.

Figure 3: ASX 200 capital allocation in H2-2018 versus history



Source: Goldman Sachs, Factset

Five observations from the reporting season

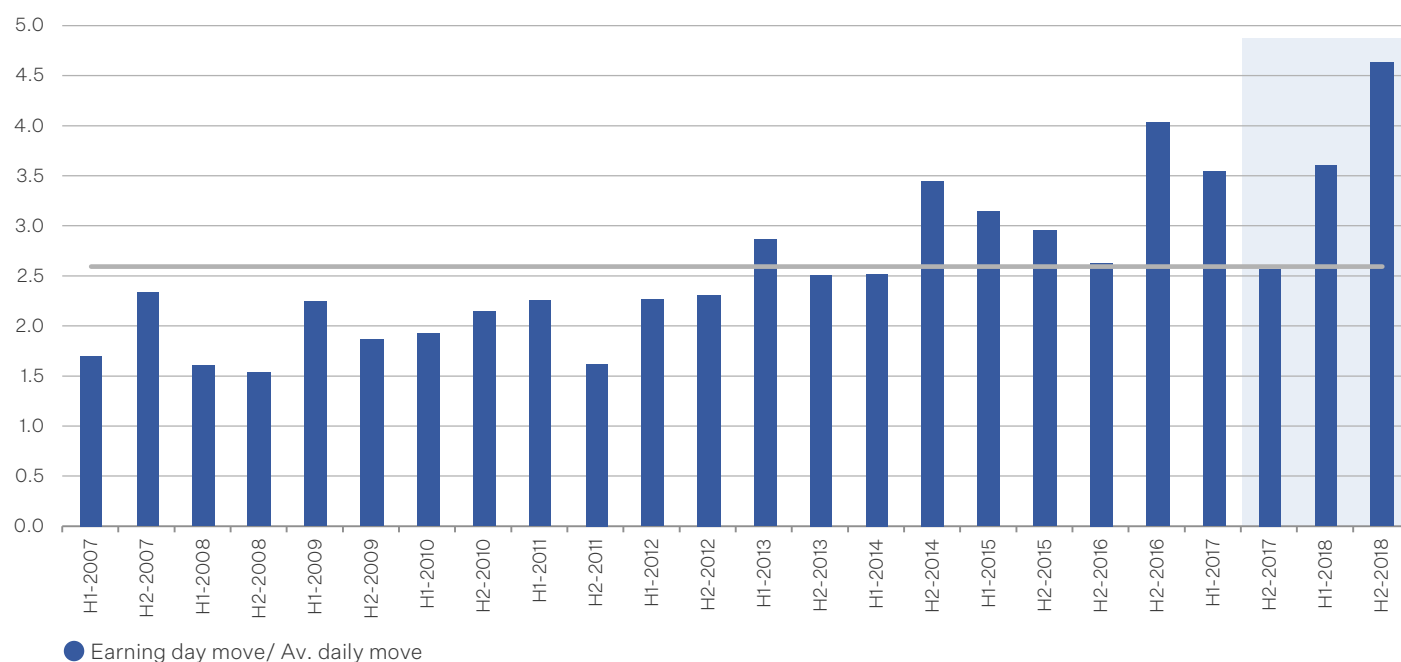
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Volatile responses to results

The reporting season saw new highs in the recent trend towards greater stock price volatility on the day of a company's result. This is demonstrated in Figure 4, which shows the ratio of a stock's share price move on its result compared to the average of the prior thirty days. We think that the increased role of systematic and quant-based strategies has been playing a role in this dynamic, given the algorithms used can generate large orders in sometimes illiquid markets. The price action that follows can also become self-fulfilling, at least for a time. Investors may see a sharp drop in a stock price following its result and back-solve for the reaction, applying an overly negative lens to a result which was in reality not that bad.

Ultimately, this trend can drive opportunities for an active investor who is able to appreciate the subtleties and wider implications of a result in a way which an algorithmic system cannot and who can then take advantage of mispricing from the large stock moves.

Figure 4: Ratio of price move on results day to 30 days prior



Source: Goldman Sachs, Factset

Five observations from the reporting season

5

Three distinct themes in stock performance

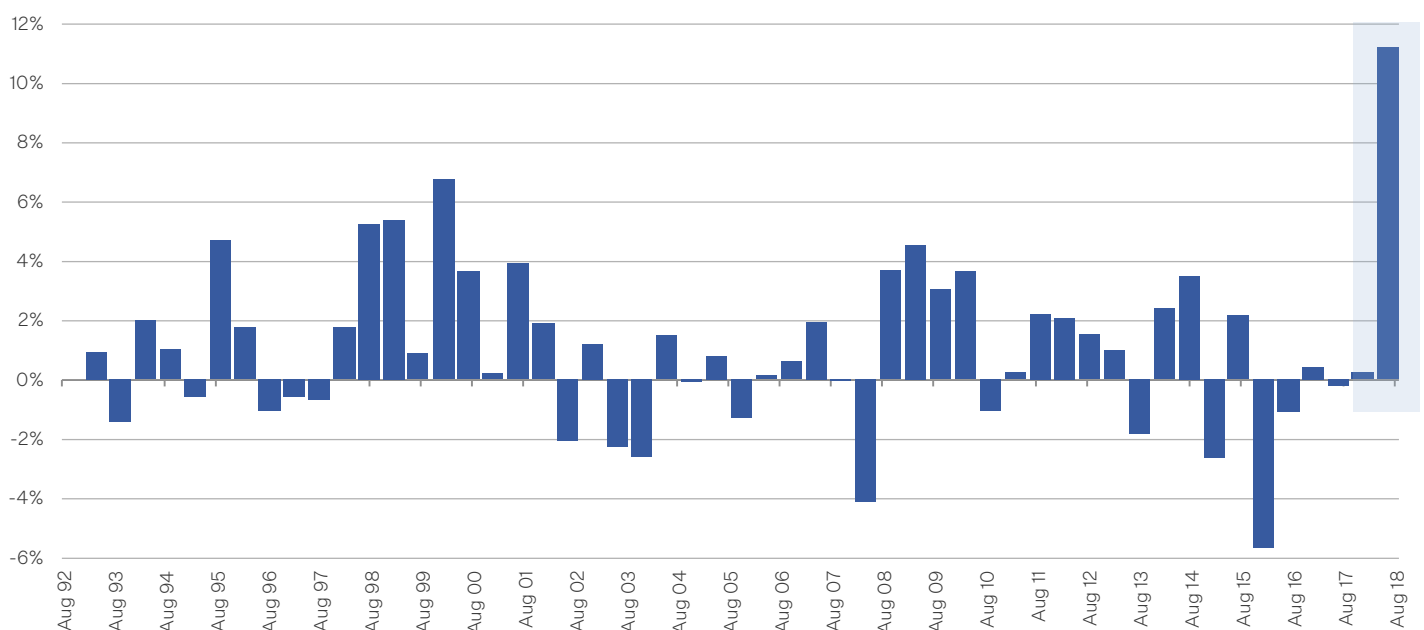
There were three broad buckets in terms of significant performance during the season. The first is the growth stocks segment – those primarily in the technology, health care and China consumer-oriented sectors which had surged ahead of the reporting season and continued to outperform through it. This shift was driven by valuation expansion. While earnings were broadly reasonable, we did not see material positive revisions.

This is at least partly driven by a lack of alternative places to invest, given the negative sentiment towards Financials and Resources. However, the scale of outperformance (see Figure 5) also suggests a degree of capitulation, with some investors chasing the sector's performance. We have seen this kind of thematic momentum blow-off before and see valuations in this sector as perhaps the market's foremost challenge at the moment. We will return to this theme later in this paper.

We also saw a group of unloved, highly-shortened stocks outperform when their results and news flow proved better than many investors had feared. JB Hi-Fi (JBH), Brambles (BXB) and TPG Telecom (TPM) provide examples here.

The final notable group includes stocks feeling the impact of government intervention. Stocks in this cohort include AGL Energy (AGL), Origin Energy (ORG) and IOOF (IFL), where the impact of government intervention through policy initiatives or the Banking Royal Commission is reflected in revenues, margins, earnings and, ultimately, stock prices. This group were notable underperformers during the season. We see increased government and regulatory activity as a key source of disruption in today's environment, making itself felt across a wide swathe of the market in areas as diverse as banking, power, insurance, telecommunications and wealth management. Understanding the nuances of political attitudes to particular industries and the relationships between companies and the Government is a critical factor for investing in today's market.

Figure 5: Relative performance of growth / quality stocks versus ASX 200



Source: Datastream, Pental 31 August 2018.

Market outlook: major themes and observations

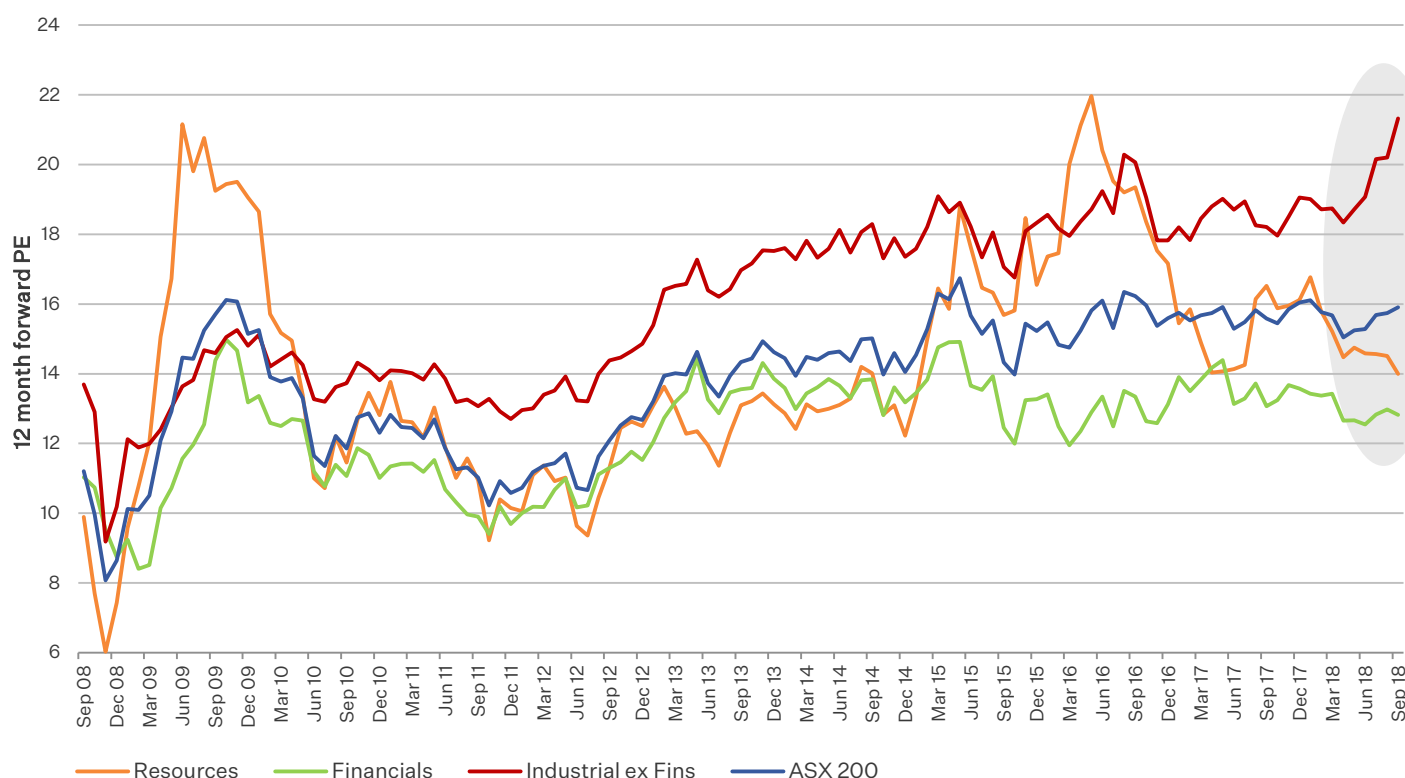
Valuation looks reasonable

In our view, the market's aggregate valuation of around 15.5x next 12-months price/earnings multiple remains reasonable. The valuation is above its long-term average, but is consistent with the low level of interest rates. While rates remain low – and we do not expect to see them shift up significantly any time soon – we think the market can maintain this valuation rating. The implication is that the index will be driven by earnings, not valuation, and the consensus expectation of mid single-digit earnings growth supports our expectation of modest but positive returns from Australian equities on a 12-month view.

Growth and defensives becoming expensive

The benign aggregate market rating actually masks a significant inter-industry divergence in valuations. The valuation dispersion between Resources and Financials on one hand, and Industrials on the other, grows ever wider and is particularly pronounced (Figure 6).

Figure 6: Price-earnings multiple of ASX 200 and key market components



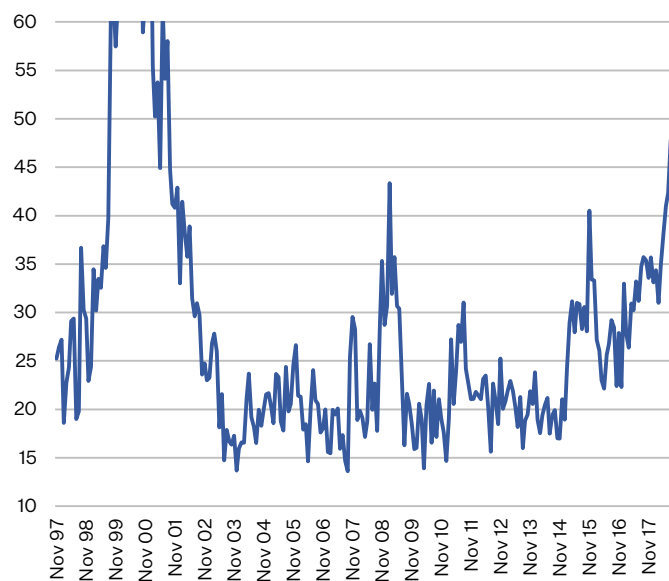
Source: Goldman Sachs, Factset

The rationale is intuitive; investors are wary of Resources given a strong run and uncertainty over China's growth and trade prospects, while also avoiding Financials given the threat posed by the Royal Commission. At the same time, this is a function of relative performance among the index heavyweights. CSL (CSL), a highly-valued growth stock, has overtaken Westpac (WBC) to be the market's third largest company by market capitalisation after Commonwealth Bank (CBA) and BHP. The implied higher weighting to growth within the Industrials sector is helping drive its whole valuation higher.

This is not a broad-based trend. It is mainly driven by a handful of growth stocks in the Technology, Health Care and Chinese consumer sectors such as REA Group (REA), Xero (XRO), CSL, Cochlear (COH), A2 Milk (A2M) and Treasury Wine Estates (TWE). These are stocks which are already in the most expensive decile of the market and where the valuation expansion has far outpaced earnings revisions. It is momentum and the hope of future growth which is often driving their share prices higher.

This is posing possibly the market's trickiest challenge. History has shown that phases where expensive stocks continue to outperform and decouple from the market can be short but very painful for investors who don't own these stocks while their upward momentum persists. Figure 7 shows that the aggregate valuation for the market's most expensive stocks has risen beyond the post-GFC highs and is now into tech-boom territory in terms of how expensive the highest-rated stocks are becoming.

Figure 7: Relative P/E of stocks in the top-quartile of valuation (P/E vs market average %)



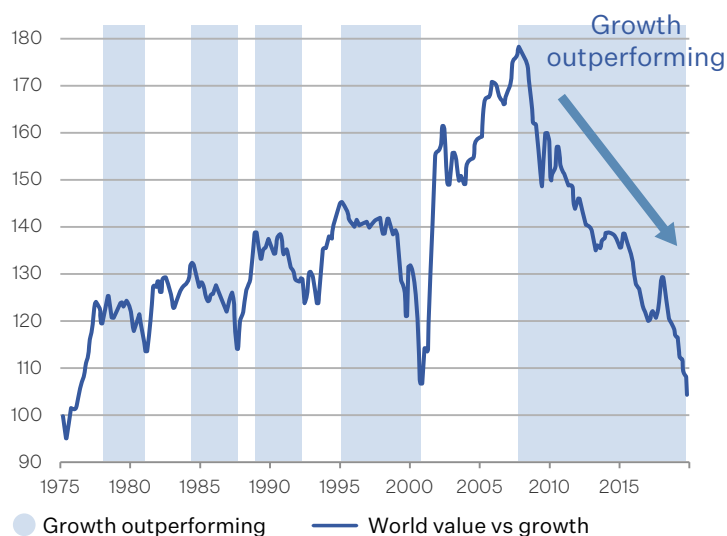
Source: Factset, Goldman Sachs Investment Research, end August 2018

The issue is compounded by the fact that it is growth stocks which comprise this expensive cohort and we are at a point where the growth stocks cohort globally has enjoyed its longest stretch of outperformance over value since 1975 (Figure 8).

The conundrum for investors is this obviously sounds warning bells and renders this part of the market vulnerable to a sharp pullback. However, while these stocks are expensive and have outperformed for a sustained period, it does not necessarily follow that they are obliged to correct any time soon. There is no obvious catalyst at this stage for what will prompt a reversal in growth stocks – although the most likely risk could be over-tightening by the US Federal Reserve.

The upshot is that any wholesale rotation from growth and into value at this point could prove to be a very painful position for some time yet. This is especially so given that value stocks are not particularly cheap. The last time we saw a correction in growth stocks was in mid-2016; value stocks were much cheaper in relative terms and offered an alternative into which investors could confidently rotate. Today, with investors nervous about Financials and Resources, the alternative sectors are not as obvious which again supports the notion that growth stocks can continue to outperform.

Figure 8: MSCI World Value vs Growth



Source: Goldman Sachs, Factset

Our response is to remain disciplined. We are underweight the growth sector as a whole, mindful of the vulnerabilities and wary of claims that “this time it is different” in terms of how these companies should be valued. We have all heard this before. At the same time, we believe it is prudent to have some exposure here, via companies such as CSL where we believe there is better fundamental support for valuations. This is consistent with our approach of driving portfolio performance via stock and industry-level risk – where we believe we have some actionable insight – rather than via thematic factors.

Resource sector reversion

The Resource sector's underperformance of recent months persisted into the reporting season, despite delivering a reasonable set of results. Clearly, sentiment towards the sector reflects the emergence of macro risks. In some cases, mining stocks have given back a material proportion of their relative outperformance since early 2016. We see this as a potential opportunity given that fundamentals remain sound; however, we need to keep a close eye on the macro situation.

Investor concern over Resources is centred on China's economic growth and demand for commodities. There are a couple of factors to consider here. The first is that demand has been slowing for the past year in response to the Government's crackdown on 'shadow bank' lending outside of the formal banking system. This was necessary in order to constrain the rate of credit growth within the economy. However, it has unsurprisingly dragged on economic growth as fixed asset investment has declined in response.

The second is the threat of escalating trade sanctions between China and the US. Should we see further sanctions placed on China's already slowing economy, it could trigger weakness in the currency, prompting possible capital flight. The last time we saw this happen coincided with poor performance in the Resources sector.

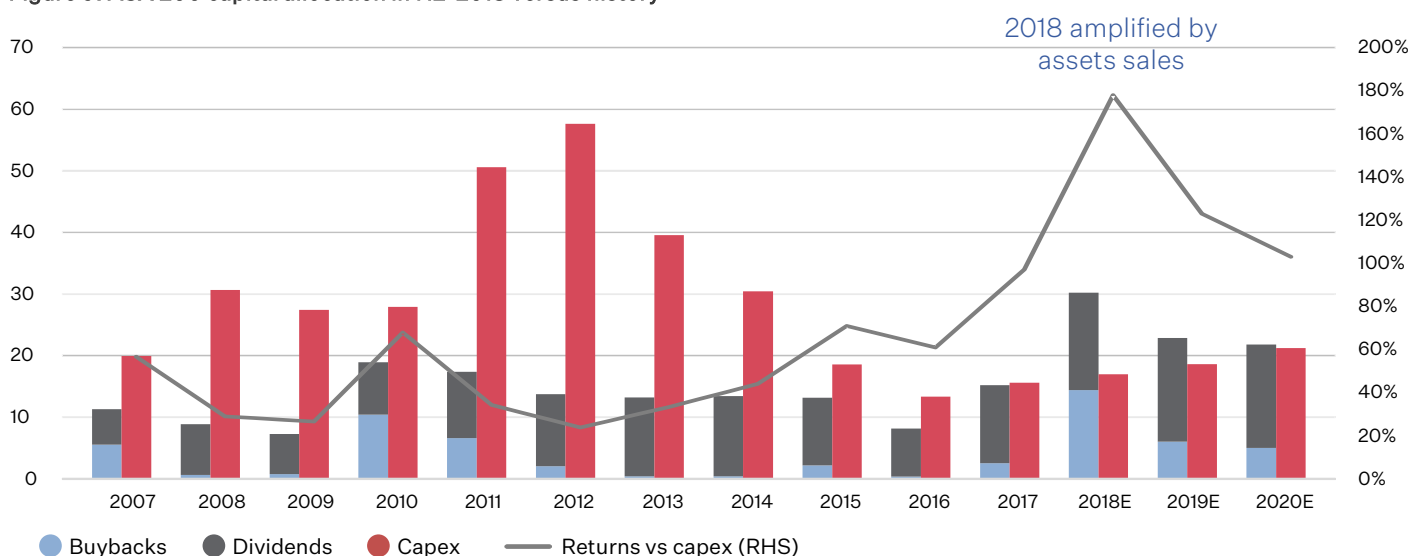
China knows it is in a vulnerable position, given decelerating growth. If the Government fails to respond to America's trade demand then President Trump will have little motivation to ease pressure ahead of the Congressional mid-term elections. There is significant risk here which could hurt resource stock performance in the near term.

Nevertheless, we believe China's most likely response to further sanctions would be a round of stimulus – most likely via increased fixed asset investment and tax cuts, which would provide the swiftest positive injection into the economy. We have been largely neutral on Resources in recent months but macro developments in the next month or two could provide an opportunity, given the sector would likely bounce on moves from China to offset sanctions.

This is particularly so, given the fundamentals in Resources remain supportive. The reporting season demonstrated that companies are seeing a tick-up in costs but that management are remaining disciplined in terms of capital expenditure (capex) and continue to be focused on returning capital to shareholders via buybacks and dividends. Figure 9 illustrates the sharp drop in capex since the euphoric days of 2011-2014 and how this has led, in conjunction with a recent recovery in commodity prices, to an increase in the ratio of return to capex. This will be inflated in 2018 by the return from asset sales such as BHP's onshore shale gas business. However, even without this the scale of cash flow, prospective returns to shareholders from the Resource sector remains attractive.

Our preference remains in oil and gas, which continues to benefit from a lack of investment in recent years. We also favour the prospects for bulk commodities such as iron ore and coal, where continued supply constraints by the Chinese can support prices. We are less positive on some of the industrial metals such as nickel and copper.

Figure 9: ASX 200 capital allocation in H2-2018 versus history



Source: Goldman Sachs, Factset

The disruptive impact of government intervention

A broad swathe of corporate Australia is dealing with the disruption of increased government and regulatory intervention, which is having a material effect on industry structure, pricing, revenues, margins and earnings. This is symptomatic of a broad shift towards more populist policies right across the western world and transcends party divides; very few politicians are keen to be seen as promoting the cause of big business in the current environment.

We are seeing the effect on banks, where the Royal Commission is already leading to significant changes as banks divest various functions and financial companies are reassessing pricing. It is also central to power, where governments are involving themselves in pricing and where the lack of a coherent federal energy policy is driving uncertainty and discouraging investment. There are other examples, all of which tend to be in sectors that have two things in common. First, they have a direct effect on how people feel about their financial situation, be it via mortgages, electricity prices, or insurance premiums. Second, they are typically areas where the Government already plays a role in terms of tax breaks or rebates, which can provide justification for political intervention. In this environment it is important to understand the nuances of the political climate and how it relates to industries where these conditions exist.

In this vein, we are still cautious on the near-term outlook for banks. They have underperformed and are now near their historical lows in terms of valuations relative to the market. Earnings growth remains low, with little signs of an improvement. In the absence of earnings the banks are unlikely to be re-rated by the market, given the continued regulatory pressure and uncertainty over the ultimate outcome of the Commission for the industry's structure. The downside seems reasonably limited from here – particularly given that we don't expect a housing crash – and dividends are attractive, but there is little to suggest that they can outperform significantly on a 12-month view.

Telecom responding – an opportunity from disruption?

It is not just the Government and regulators driving disruption; new technology and competition continue to play its part in other sectors of the economy such as retail and supermarkets. Recent moves in the Telecommunications sector provide a good example of how investment challenges and opportunities can play out in response to a disruptive threat.

TPG Telecom's (TPM) move to position itself as an aggressive fourth player in the mobile phone market has led to angst and uncertainty which has weighed on the price of Telstra (TLS) in particular over the last 12 months. This culminated in Telstra downgrading its profit guidance and writing down the value of assets in June, acknowledging that competitive intensity was going to take a large bite out of its earnings.

That said, it has also been clear that an industry structure generating low returns but requiring a large amount of capital was unsustainable; something has to give. In this case it was the tie up between the third player, Vodafone, with TPG Telecom. We believe that while the industry remains very competitive, the participants do not face the existential threat that was priced into companies such as TLS a few months ago, when its valuation declined to a low point of 9x next-12-month price/earnings. We believe that, having rebased earnings and working on taking costs out, there are some signs of tailwinds emerging for TLS, whilst remaining mindful of the significant execution risks that remain. It is another good example of the opportunities that can emerge from disrupted industries when the market gives up on a challenged stock.



Conclusion

We expect the recent growth in Australian equities to continue at the same relatively modest rate, driven by earnings and a relatively supportive domestic economy. The current market also features unprecedented disruption from multiple sources - significant macro uncertainty, bouts of unusual price action, and pockets of extreme valuations. While this is challenging, ultimately this also provides a fertile hunting ground for active managers who have a deep understanding of companies, their management, and the structure of the industry in which they operate. With increased dispersion in stock performance, it is an environment in which the hard work of research and gaining insight is finding itself rewarded.

As always, we build our portfolio to be driven by different types of stocks so that it is not reliant on the success of one particular theme or sector. Our current ideas include the following.



Qantas

Attractively valued industrial cyclical.

A stable and supportive industry structure should support revenue and help the company offset the headwind of increased fuel costs. Strong cash flow and capital management discipline is seeing a significant return of capital to shareholders.



Santos

Resource exposure. Enjoying the benefits of recent increases in efficiencies and cost reductions which have increased operational leverage to a higher oil price. A lack of oil/LNG investment globally helps constrain supply and provides a supportive environment.



Telstra

An early-phase turnaround. An unloved stock due to increased competitive intensity, there are signs that, having re-based earnings expectations, an improved industry structure and significant self-help can lead to a reversal of recent negative trends in earnings.



CSL

Reasonably-valued growth. While its headline P/E is at historical highs, strong underlying momentum provide more support to CSL's valuation rating than is the case with many other growth stocks. CSL is benefiting from a growing market for its products as well as increased market share as its competitors face issues with plasma collection.



Metcash

A later-phase turnaround. We believe the market has under-valued the IGA franchise business on broad fears about increased competition within the supermarkets sector. Significant self-help measures are helping offset revenue pressures and supporting earnings, while management have also started buying back shares.



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