HD Result Season Previews

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- Earnings growth needed to justify PE - Risk to the downside - Revenue growth important

By Greg Peel

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The consensus FY14 earnings growth forecast for the Australian market is sitting at 13% (year on year) or 9% ex-resources, notes UBS. At the previous reporting season six months ago, those forecasts were 14% and 9% respectively. The consensus forecast for FY15 is sitting at 5.2%, down from 8.5% six months ago. The difference is mostly explained by **mining** sector downgrades (**iron ore** price driven) and to a lesser extent, downgrades for industrials ex-banks, notes the broker.

While the current price/earnings ratio on the market ex-resources is 6% above the long-run average and industrials ex-banks specifically is 10% above, the broker is not calling "overvaluation" given historically low interest rates. That said, UBS suggests the anticipatory PE expansion phase is now over and investors will be looking for earnings (E) to fulfill the expectations suggested by price (P) within the current PE.

UBS analysts are marginally more cautious on earnings than they were six months ago, given weaker **iron ore** prices, a stubbornly high Aussie dollar and subdued revenue growth. The broker has cut its year-end target for the ASX200 to 5625 from 5700, and has listed its potential up/downside result surprises from individual stocks as follows.

Potential to surprise to the upside: CSL ((CSL)), Genworth Mortgage Insurance ((GMA)), Harvey Norman ((HVN)), ResMed ((RMD)), SMS Management & Technology ((SMX)), Sonic Health Care ((SHL)) and Woolworths ((WOW)).

Potential to surprise on the downside: Brambles ((BXB)), Coca-Cola Amatil ((CCL)), Cochlear ((COH)), Domino's Pizza ((DMP)), GWA **Group** ((GWA)), Monadelphous ((MND)), Myer ((MYR)), NRW Holdings ((NWH)), OrotonGroup ((ORL)), Premier Investments ((PMV)), Toll Holdings ((TOL)), Trade Me **Group** ((TME)), Treasury **Wine** Estates ((TWE)), Wesfarmers ((WES)) and WorleyParsons ((WOR)).

Goldman Sachs expects earnings revisions during the reporting season to skew to the downside, citing several factors.

The domestic economy weakened in the June quarter from the March quarter as housing momentum slowed and consumer spending fell post-budget. The Aussie is up 8% since the February reporting season. Consensus expectations suggest a strong second half FY14 given relatively few downgrades in the confession session. Despite the headwinds of fiscal contraction and weak household income, consensus expectations are for a strong recovery in earnings in FY15 for cyclicals.

Moreover, the starting point for industrials valuations is 4% higher than it was in February, Goldman notes. The broker does, however, expect cost cutting programs among corporates and the prospect of another RBA rate cut to provide some offset to risks.

Goldman has identified stocks for which market expectations are low going into the result season (implying upside risk) and those for which expectations are high (downside risk). Of course this doesn't mean the market is not "right" to have low/high expectations.

On the low side are Fortescue Metals ((FMG)), Southern Cross Media ((SXL)), Downer EDI ((DOW)), Cardno ((CDD)), Arrium ((ARI)), JB Hi-Fi ((JBH)), Cabcharge ((CAB)), Kathmandu ((KMD)) and IOOF Holdings ((IFL)).

On the high side are Oil Search ((OSH)), Echo Entertainment ((EGP)), AWE Ltd ((AWE)), Santos ((STO)), Federation Centres ((FDC)), Transpacific Industries ((TPI)), Aurizon ((AZJ)), Challenger Group ((CGF)), Ramsay Healthcare ((RHC)) and Investa Office ((IOF)).

Goldman has also identified those stocks which saw earnings up/downgrades early in the year, but nothing recently (implying further up/downside risk). Those upgrading a while back include Fairfax Media ((FXJ)), Magellan Financial ((MFG)), Seek ((SEK)), Henderson Group ((HGG)), TPG Telecom ((TPG)), REA Group ((REA)), Perpetual ((PPT)), Breville Group ((BRG)) and Boral ((BLD)). Those downgrading a while back include Goodman Fielder ((GFF)), Treasury Wine, Coca-Cola Amatil (CCL)), Cochlear, Sims Metal Management ((SGM)), Transfield Services ((TSE)), Nufarm ((NUF)), Santos and Ansell ((ANN)).

Those stocks for which consensus suggests the second half will be stronger than the first (implying risk of falling short) include GWA, Cochlear, McMillan Shakespeare ((MMS)), Worley, Lend Lease ((LLC)), Perpetual, Suncorp ((SUN)) and Flexigroup ((FXL)). Those for which consensus suggests the second half will be weaker than the first include Monadelphous, Fortescue Metals ((FMG)), Cabcharge, Seven West Media ((SWM)), BHP Billiton ((BHP)) and Bradken ((BKN)).

Again we must put such facts into context. For example, weaker expectations for the miners can be easily put down to a lower iron ore price. Weaker expectations for Seven can be put down to the election pumping up ad revenue in the first half.

Goldman has also looked ahead to FY15, which will offer up/downside risk at the FY14 results based on initial guidance and/or simple outlook comments. (it is worth noting at this point more and more stocks report on a calendar year, so FY-FY comparisons also apply for second half 14-first half 15 comparisons.

Stocks with a strong FY15 consensus forecasts going into the FY14 results, suggesting risk of outlook disappointment, include Cochlear, McMillan, Goodman Fielder, Nufarm, Santos, Treasury Wine, Kathmandu, GUD Holdings ((GUD)) and Navitas ((NVT)).

Stocks with a weak FY15 forecast include Arrium, Fortescue, Lend Lease, BHP, Woodside Petroleum ((WPL)) and Cabcharge.

Macquarie agrees with UBS that it is important for earnings to live up to expectations this result season. The market and individual sector PE's have "normalised" over the last 18 months, the broker notes, meaning they've recovered from their GFC depths, but investors are now doubting sustained earnings growth. Hence share prices are now highly vulnerable to earnings "misses".

Having said that, Macquarie argues such a view ignores the increasing divergence of earnings growth and risk. The broker believes there exists a selection of investment opportunities offering above average growth and no greater than average risk, which should stand out this season.

The previous reporting season was highlighted by the first period of revenue growth acceleration, the broker notes, after two years of earnings growth driven by margin expansion (achieved on deleveraging and cost cutting). Australia's economic recovery is currently slow and patchy, thus investors will be closely watching the level of revenue growth achieved within earnings results. Companies with greater opportunity offered by offshore exposure should fare better, the broker suggests.

Macquarie's selection of stocks with stronger than average FY14 revenue growth forecasts and earnings forecasts equal to or exceeding FY13 is as follows: Seek, Bluescope ((BSL)), REA Group ((REA)), CSL, Computershare ((CPU)), Goodman Group ((GMG)), Sonic, Commonwealth Bank ((CBA)), Bendigo & Adelaide Bank ((BEN)), Sirtex Medical ((SRX)), Ainsworth Gaming ((AGI)), Ansell, Fortescue, Carsales.com ((CRZ)), Greencross ((GXL)), Corporate Travel Management ((CTD)), Slater & Gordon ((SGH)), Perpetual, IOOF, Challenger, Ardent Leisure ((AAD)), Steadfast ((SDF)) and JB Hi-Fi.

Deutsche Bank also notes that while FY14 earnings forecasts held up well throughout most of the period, the past couple of months have seen some weakening. The earnings revision ratio has fallen back to about average, and FY15 consensus has already been cut before the year has begun.

Deutsche echoes observations of lower commodity prices, which the broker attributes mostly to a cooling Chinese property market, consumer sentiment hit by the budget, a stronger Aussie in the June quarter (albeit down 10% on the June quarter 13), and shakier looking European growth, highlighted by a decline from earlier levels of industrial production growth.

The one saving grace is that housing construction began to ramp up in the June quarter, notes Deutsche.

With regard Macquarie's revenue considerations, Deutsche is expecting overall limited FY14 revenue acceleration and little movement in margins, and notes only mild improvement expected in revenues for FY15 but significant margin expansion. This may be supported by ongoing efficiency drives at a number of companies, the broker suggests.

Deutsche also raises the subject of **M**&A, noting a rush of activity offshore suggests Australian activity is set to pick up as well. The broker expects questions to be asked of management during result briefings, and further notes corporate gearing is now below average. Net debt to **equity** is down to 38% overall versus a 51% average, and down to 34% for resources versus 43%.

Deutsche has otherwise kept it simple, merely suggesting stocks could surprise to the up/downside next month. The upside list includes Aurizon, BHP, CBA, Echo, Federation Centres, Insurance Australia **Group** ((IAG)), James Hardie ((JHX)), Orora ((ORA)), Rio Tinto ((RIO)), Seek, Suncorp and Worley. The downside list includes Amcor ((AMC)), Arrium, Computershare and ResMed.

CIMB is a bit more forthright than most brokers, declaring "we see significantly more downside risk to EPS [earnings per share] estimates this reporting season than last year". The strategists do remain confident earnings growth will continue thereafter, but only after a reset of expectations to a lower level.

CIMB singles out the resources and engineering contractor sectors as most at risk, given a late rush of downgrades. The broker would **buy** those domestic cyclicals most hit by the budget blues.

Earnings growth will still be dependent on cost cutting, suggests CIMB. BHP, Rio, Iluka Resources ((ILU)) and **Alumina** Ltd ((AWC)) have all been trying to rein in costs, the strategists note, while those companies successfully managing costs to date include REA, JB Hi-Fi, UGL Ltd ((UGL)) and Aristocrat Leisure ((ALL)).

CIMB warns that despite earnings downgrades for resource sector stocks, the combination of lower commodity prices and a higher Aussie means downside risk still remains for the likes of Fortescue, Atlas **Iron** ((AGO)), Arrium, Mt Gibson **Iron** ((MGX)), Newcrest **Mining** ((NCM)) and Sandfire Resources ((SFR)).

Weaker consumer sentiment from the budget blues and the warm autumn would have the broker trimming positions in Myer, JB Hi-Fi and Breville before reinstating positions after result announcements. CIMB believes Seek and GUD are worth buying ahead of their results. Hang on to Downer but sell it afterwards, but exit Worley, Transfield and Sims Metal now.

Get out of Cabcharge and Qantas ((QAN)) given budget blues. Downside risk for QBE Insurance ((QBE)) is limited while CBA seems to be exhibiting upside momentum. Sell ASX ((ASX)) given weaker trading volumes.

Finally CIMB has made note of stocks which have seen significant increases in short positions in the **lead**-up to result season. Retail and resources dominate, with JB Hi-Fi, Myer and Super Retail ((SUL)) and Fortescue, Atlas and Mt Gibson all becoming more popular with shorters.

The implication here is that an upside surprise would spark an exacerbated rally on short-covering, while any drop on a downside surprise would be muted on short profit-taking.

For a comprehensive list of the most shorted stocks in the market, see FNArena's regular Thursday Short Report.

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CO bkhlp : BHP Billiton Ltd | ubs : UBS AG | bltplc : BHP Billiton PLC

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