

Reporting season

What to look for this reporting season

Mark Story - August 21, 2008

Considering that we're experiencing the toughest economic back-drop to a reporting season since 2000-01, revelations that earnings downgrades outnumber upgrades by a ratio of two to one shouldn't surprise.

Unsurprisingly, the focal point of reporting season is arguably outlook statements. And as many stocks, including Alesco, Lihir Gold, Monodelphous, Boral, Iress and Computershare recently discovered, merely posting a FY2008 result in line (or above) expectations will do little to nudge the share price forward. Given the economic headwinds, share price fortunes are acutely wired to underlying commentary about the future. And where there is insufficient guidance on future earnings, the market is happy to 'sell the rumour'.

Despite a 20%-plus jump in full-year net profit to \$US282 million, investors thought there was sufficient uncertainty within Computershare's underlying commentary to sell, and the share price closed 5.3% lower. And while Alecso reported a 31.8% lift in net profit, company warnings that the outlook for fiscal 2009 was challenging drove the share price 10% lower.

Now that we're deep into the heart of reporting season, it's clear that the shoe is beginning to drop on downgrades. But on an encouraging note, incremental bad news, compounded by more hemorrhaging on Wall St hasn't (yet) delivered incremental new lows on main indexes.

Rising input costs in the form of both materials and labour, have been a recurring theme among recently issued profit warnings and downgrades. Other key themes likely to define future earnings include currency, geographic exposure, non-residential construction, and management changes in-store for many companies (especially within over-gearred property and infrastructure stocks).

While robust top-line growth during the first three quarters of the 2008 financial year more than compensated for cost and margin pressure, the chickens are now coming home to roost.

According to Shane Oliver head of investment strategy with AMP Capital, consensus expectations for 5% to 10% growth in the non-mining markets are way too strong and will eventually be revised down. Overall profit growth for 2007-08 is expected to come in at a feeble +3%, down from +15% in the previous financial year.

Three weeks ago, suggestions that the A\$ could suddenly drop 12% and that interest rate cuts were imminent, would have looked counter-intuitive at best.

Nevertheless, Citi analysts' still see interest costs as a millstone around future profit growth. Their earnings forecasts for the market as a whole expect profit margins to narrow, rather than widen as they did in 2007. The contribution of

profit margin changes to forecast earnings growth (for FY2008) now stands at -1.6 percentage points versus -0.6 percentage points at the end of February 2008 and +5.0 at the end of September 2007.

Meantime, the contribution of interest changes to forecast earning growth (for FY2008) at -4.1 percentage points contrasts with the +1.9 percentage points contribution Citi forecasted for FY2008 back in September 2007. "Given our late cycle themes of slowing growth combined with sticky costs, we view some of the FY2009 numbers with caution," says Citi's analyst Graham Harman. "The 3.5 percentage points contribution from operating margins would appear to be a challenging number to meet considering the stage of the business cycle we're entering."

A mixed start to reporting season saw better than expected results from Astar, Alumina, AXA Asia Pacific, JB Hi-Fi, OneSteel, Boral, Ansell, and Resmed, but worse than expected results from Alesco, Seek, Corporate Express, NewsCorp and Hills Industries.

Respectable profit updates from Commonwealth Bank, and Westpac helped staunch further hemorrhaging within financials following drastic profit downgrades from Suncorp-Metway and surprise write-downs from National Australia Bank and ANZ. Resonating loudly from banks this reporting season are overtures that credit quality deterioration is finally over, and assertions that headwinds will dominate the outlook for global banking.

Market price action so far this reporting season has been dramatically negative compared to recent years, and it's the non-resources sectors that have fared worst in the downgrade stakes. Over the last six months resource stocks have been strongly upgraded on the back of bulk commodity price rises, while industrials have been downgraded on rising costs, the softening domestic economy, and the credit crisis.

While some relief should be in-store through lower interest rates and a lower \$A, earnings expectations for "industrials" (i.e. S&P/ASX200 ex-Resources) are now in negative territory with Citi analysts expecting -4.7% EPS growth for fiscal year 2007/08, (reaccelerating to 6.1% for 2008/9).

At face value, market expectations of 60% growth from resources appear reasonable given the latest surge in coal and iron ore prices. Citi's EPS growth for the resources sector has increased over the last four months. But at 14.9% it's already clear that cost pressures are starting to bite, and mid-cap miners are likely to be main casualties.

Interestingly, not even BHP Billiton's strong profit result could stop heavyweight miners from tracking base metals prices lower. While BHP's \$US15.39 billion FY08 net profit was (only) in line with analysts estimates, confidence about 09 was sufficient to reaffirm broker buy recommendations on the stock.

While Goldman Sachs JBWere expects resource companies to report significantly higher input costs, mining services firms (so far) appear relatively unscathed. Three stocks dependent on the resources industry for their business growth - United Group, Bradken Ltd, and Worley Parsons - all delivered standout results in the year to June. But it was management assurances that there's sufficient demand to boost earnings again this financial year that drove their share prices forward.

