Touchstone Investment Insights

The wrap on reporting season

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TOUCHSTONE Asset Management

A Bennelong boutique

In the post GFC environment, many investors focused principally on one number during reporting season – revenue growth. The implied justification was that due to quantitative easing, capital was abundant (and extremely low cost), which made cashflow and balance sheet analysis somewhat less important. Inflation was also persistently low, so cost growth was generally not an issue.

2022 saw the long overdue normalisation of interest rates, and with it the end of this way of thinking. In 2023, markets were abruptly reminded that the value of a company is a function of its present capital structure and its future cashflows. So, the questions to ask during reporting season are: 1) did the company finish the period with more or less assets or liabilities than expected, and 2) is there anything that offers an insight into the level of profit and cashflows the company will generate in future? With that in mind, in this article we review the February 2023 results.

Overall, this reporting season we found around 13% of ASX-200 results beat and 28% missed, with the misses skewed to smaller companies. This ratio of 45% beats to misses is the lowest we have observed in five years, well below the average of 76%. The price reaction to results was greater for misses than beats, with misses punished more than historical experience. This is symptomatic of deteriorating economic conditions.

It’s also concerning that the strongest sector for beats was consumer cyclicals (beats to misses of 175%). This sector was the beneficiary of unsustainably strong consumer spending and is expected to be the most impacted in 2023 from higher interest rates. In fact, we expect it will likely be a good source of misses in future earnings periods.

Revenue was strong, boosted by inflation

Strong revenue was somewhat expected in the results given high inflation and the resilience of the domestic economy in 2022, which supported both higher volumes and prices. Overall revenue beats outnumbered misses by more than 3 times. This pricing power was particularly notable in some industries such as online classifieds (real estate, autos and job ads), supermarkets, insurance, and telcos.

The weakness was particularly notable in businesses with European exposure and in some commodities, where softening demand meant realised prices were lower than the headline commodity indices. This issue with commodity pricing is one we have been expecting to show up in reported numbers, with particular weakness expected in prices realised by the lithium sector. As the global economy slows, we expect this will continue to be an issue for Resources companies. It was notable that the miss to consensus earnings in Resources occurred despite persistent downgrades over the preceding 6 months.

Large misses in operating margins (which we expect to continue)

Since the outbreak of COVID, analysts have struggled to incorporate volatile cost movements and operating leverage into earnings. This reporting season was no different, with 40% of companies missing expectations for operating margin. This was largely due to higher costs, particularly for labour and energy.

While most companies think input cost increases are moderating and supply chains are normalising, labour markets remain relatively tight. While we concur with the RBA that inflation has probably peaked, the risk is that inflation remains elevated. It was notable that Brad Banducci, CEO of Woolworth, said, “We underestimated how long it takes for things to flow through the value chain … Cost inflation in areas like wages, energy and supply chain remains material and well above recent history”. Contractors are particularly exposed to high labour costs, with Monodelphous commenting that “labour shortage remains the most significant challenge”.

An alternative indicator regarding the tightness of labour markets was the worsening safety metrics of many companies in the most recent reporting period. Jarden recently completed work showing that amongst the Mining and Oil & Gas sectors, Total Recordable Injury Frequency Rates (TRIFRs) rose for 45% of the companies they analysed, with seven fatalities at listed and unlisted miners. Among the Industrial sectors similar trends were found, with their hypothesis that this may have been at least partially caused by labour issues – including a lack of skilled and semi-skilled labour, higher staff turnover and increased use of contractors.

Debt levels and interest costs come back into focus

Another line of the P&L that mattered more than it has in recent history was interest expense, with higher interest costs on average a 3.5% drag on Industrials earnings growth. Leverage generally remains low, although for many corporates – most notably the Real Estate Investment Trusts (REITs) – it is clearly pressuring earnings.

We note that across our REIT universe the average cost of debt rose ~30% in 1H23 and ~45-65% for some of the lower quality names. This is expected to worsen, with distributions at risk and even the potential for recapitalisations if conditions deteriorate. Dexus said “the macroeconomic environment remains challenging … Higher interest rates will continue to impact our results in FY23”. GPT similarly commented that “higher cost of debt is a headwind for 2023 FFO growth”.

More recently, we’ve noticed that some of the smaller companies outside our investment universe may be unable to refinance debt, with highly dilutive raisings or changes of control the likely outcome. While the interest cost on debt has already increased, the spreads that corporates pay over benchmark rates (to account for risk) could still widen significantly, meaning interest costs may continue to rise even as central banks stop their tightening.

Preserving cash the focus while management remains cautious

While the P&L is the part of a result that gets most of the headlines, it is often the cashflow statement that is the greater source of truth – and the first half of FY23 saw a sharp deterioration in cashflow. Only 16% of ASX-200 companies reported strong (>100%) cashflow conversion (operating cashflow / profit) vs 28% reporting weak (<80%). This ratio of 57% was well below the average of the past five years of 87%, driven largely by working capital and continued high levels of inventory. The inventory deterioration was at least partially driven by channel destocking as those companies near the consumer prepare for weaker future demand. We note that Australian corporates inventory levels are below trend versus the US.

While operating cashflow was already weak, the equally revealing part of the cashflow statements was what companies did with their free cashflow. In short, they chose to do nothing; hardly a sign of buoyant optimism. Despite several capital expenditure blowouts owing to the cost and availability of labour and parts (particularly in mining), capex for the market overall came in below expectations. Similarly, payout ratios were around 3% below expectations. Overall, 52% of industrial and resource companies reported free cashflow (after dividends and capital expenditure) that was materially (>10%) below expectations.

Scans of company transcripts found that management sentiment generally leaned negative and had deteriorated since full year results in August 2022. Sentiment was worst in utilities, packaging and building materials.

Consensus earnings remain optimistic

Consensus earnings for the Australian market have been largely flat overall for the last 10 months, following a large increase in early 2022. Reporting season saw around 34% of stocks receive earnings upgrades, with 64% downgrades.

In terms of the revisions, a skew to downgrades is typical and this season was no different, with the average upgrade +2.7% and the average downgrade -4.9%. The aggregate downgrade for the ASX-200 of around 3% for FY23 and 2% for FY24 was driven by energy, transport, utilities and consumer durables, although several companies reported weak results but maintained full-year guidance. Consensus industrial estimates now suggest that full year earnings will be skewed to 2H23, which is at odds with the usual practice of around 56% of earnings being generated in the first half and 44% in the second half. This highlights a risk to FY23 earnings, but we are still seeing upgrades by analysts in our portfolio stocks such as Qantas, Wesfarmers and CSL.

In Australia, the ASX-200 earnings are ~13% above trend with consensus earnings per share (EPS) growth for FY23 of ~5% driven by growth in industrials of more than 20%. This extreme level of growth is driven almost entirely by a small number of COVID impacted stocks for which earnings are recovering. QAN alone contributes 40% of the Industrials growth in FY23, with the general insurers (QBE, Suncorp, IAG) another third. Consensus growth in each of FY24 and FY25 is still marginally positive, although this reflects large falls in earnings for Materials (-8%) and Energy (-30%) and a large rise in Industrials (+30%), with around 70% of this expected rise in Industrials earnings based on margin expansion. While slowing inflation may support margins, we expect this may be more than offset by lower pricing power, more competition and lower volumes.

… too optimistic

Given the deterioration in reported results, and the deterioration in quality which often precedes further falls in reported earnings, we continue to think consensus forecasts are too high.

This logic has solid fundamental underpinnings. To start, a US recession is probable. Some recent work from Minack Advisors showed that earnings have become increasingly sensitive to cycle downturns over the past 35 years, with the suggestion that US EPS would likely fall 20-30% in even a moderate recession.[1] We also note that global monetary conditions in the past have led earnings by around 18 months and valuations by around 12 months. The global reduction in liquidity is therefore expected to weigh on earnings and the market over the next 12 months.

In Australia we are less pessimistic about the economy and the earnings outlook than the US, although we're only just starting to see the real economic impact of higher inflation and interest rates. The CEO of Commonwealth Bank, Matt Comyn, recently said, "Across the board from a business perspective, trading conditions are really strong … but if you look at consumer sentiment and intentions data, you would think we are in the middle of pretty significant economic shock – which we aren't."

The change in behaviour in response to higher interest rates and overall costs from both consumers and corporates is only just beginning. The full impact will become particularly acute over the next couple of quarters as households face a peak in mortgage resets, which is expected to lead to a sharp deterioration in consumer spending and economic growth.

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[1] Gerard Minack, Minack Advisors, 'Downunder Daily: Equities often expect a soft landing, and are often wrong', 23 March 2023

Buying quality companies at reasonable prices remains the best strategy

Given the uncertain macro-economic environment and potential policy responses, we continue to see value in owning quality companies that will be relatively resilient to negative external forces. Overall market valuations look reasonable at just over 14x (versus the long-term average closer to 15x), but this masks a high valuation for industrials ex financials (over 23x, versus long-term average of around 18x). Resources are trading just below 10x (versus the long-term average of around 14x), reflecting an expectation that commodity prices will fall over the medium term.

We have recently been able to add new stocks to the portfolio and as the year progresses and the downturn matures, we expect to have the opportunity to add further high-quality companies that have used the turmoil of the past few years to consolidate market share, hire good people from weakened competitors, reduce costs or opportunistically acquire cheap assets. These companies might operate in more cyclical sectors and thus offer more upside as the cycle turns.

While this is certainly not an easy time to invest, we expect 2023 to provide plenty of opportunities for fundamental active managers.

Touchstone Asset Management is an Australian equities manager, established as a joint venture with Bennelong Funds Management in 2015, with an index unaware approach to investing in quality companies at reasonable prices. It aims for improved long-term investor returns, while also providing downside protection in adverse markets.

The team manages a range of individual mandates for institutional clients as well as the Touchstone Index Unaware Fund. The strategy primarily selects from the S&P/ASX 300 Index and typically holds 15-25 securities. It seeks to invest in good quality companies, particularly those with a significant share of expected returns coming from sustainable dividends, if available at reasonable prices.

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