September 2016

REPORTING SEASON KEY TAKE OUTS

WHAT WAS THE UNDERLYING THEME OF REPORTING SEASON?

- Earnings were broadly in line – EPS delivery of -11%.
- Resources were expected to be weak and they were on the back of lower commodity prices.
- Industrials delivered a -1% outcome on earnings.
- Revenue growth still modest – similar to previous Reporting Seasons.
- Cost-out opportunities seem to be exhausted and margins starting to become compressed, especially within industrial companies.
- Resource companies took out more cost than the market expected which was positive for margins. Continuing increase of production and firmer spot prices was a benefit for the resource companies.
- Sectors that delivered strong results across the board:
  - General retail
  - Building materials
  - Casino companies
- Not as strong were insurance companies, banks and telcos.

STAND-OUT RESULTS

- Treasury Wine Estates – delivered a strong result with strong cash-flow. Market took the result very positively.
- BlueScope Steel – delivered a stong result on the back of stronger steel spreads from East Asia and cost-out opportunities at Port Kembla being realised early than expectations. A strong building market also supported that result.
- Retailers – Harvey Norman, JB Hi Fi and Nick Scali – delivered strong results due to the strength in the housing market.

UNEXPECTED RESULTS

- Insurers – IAG, Suncorp and QBE – highlighted weakness, especially in the commercial insurance market. Increasing claims costs hit profitability across the board. NSW CTP started to see increasing incidence of claims – this also started to hurt profitability.
- CSL – delivered a result that was in line, but guidance was below expectations. Their newly acquired flu business – where market expectation was to break-even this FY – has been pushed out by a year. This has really hurt market expectations.

WHERE INVESTORS SHOULD LOOK TO FIND VALUE?

- Woolworths – a multi-year turn around. Have seen a lot of change, at the board and management level.
- Foundations in place for a turnaround to happen, it's now about the execution.
- Operational changes in place to improve profitability
- New KPIs in place introduced for top 100 executives. We believe this will drive the right behaviours for the business to turn around.
- They have the right metrics in place for the business to move forward.

BOND PROXY STOCKS OVERVALUED – IS THIS TREND PLAYING OUT AND WHY?

This trend is defiantly playing out with interest rates at all-time lows. They cannot stay this way forever so looking through the cycle is key when valuing these companies.

A great example of the trend playing out in the market is property trusts. They are all trading at 30-50 percent above NTA which is an extreme valuation. Specifically when we look at Transurban, a highly-geared vehicle which has all the tail winds of low-interest rates, but not pricing in any prospect of interest rates being higher.

BANKS – WHERE TO FROM HERE

Australian banks look cheap on relative multiples – relative to their historical multiples – and where they are trading versus the market today.

Perpetual is cautious on where the banks are in the cycle due to low interest rates and the housing market close to all-time highs.

There are a lot of headwinds in front of the banks and the market expects a benign outcome, though Perpetual believes it pays to be cautious. If this is not the case there is a lot more downside even if they look cheap relative to today.

Perpetual