March 2017

REPORTING SEASON KEY TAKE OUTS

OVERVIEW OF THE RECENT REPORTING SEASON

- Overall, the recent reporting season was very solid.
- Areas that were expected to deliver strong results – such as resources and housing-related exposures – did deliver on those expectations.
  - Housing-related exposures relate to retailers such as JB Hi-Fi, Harvey Norman and Nick Scali, which benefited from people buying property and/or renovating and needing to spend on the types of goods sold in these retailers.
- The results, whilst strong overall, haven't broadly led to upgrades on forecasts for the full financial year.
- Sectors that delivered better half-on-half growth included banking and insurance in particular.
- Pockets of weakness this reporting season included gaming, telecommunications and traditional media companies.
- Dividends were strong across the board, with payout ratios increasing across the market.
- A number of companies announced capital returns to investors, with new share buybacks being announced by AMP, Coca Cola and Bluescope amongst others.

STAND-OUT SECTOR: RESOURCES AND COMMODITIES

- Resources as a sector delivered very strong results this half, driven by commodity prices that were well above the market's expectations of them 6-12 months prior, along with strong cost discipline which has allowed many firms to de-leverage their balance sheets much more rapidly than market expectations.
- These stronger results have allowed resource firms to reward shareholders by providing higher-than-expected dividends, as well as Rio announcing a share buy-back.
- We are cautious around the sustainability of commodity prices as they stand today.
- We remain cautious around mining companies in particular when we look at the supply and demand trends for both bulk and industrial commodities.
- We will look for better opportunities before investing further in this sector for our investors.

SECTOR BY SECTOR TRENDS THIS HALF

- The banking sector delivered strong results with revenue and expense management both at better-than-expected levels.
  - Banks had solid credit quality this half. Our view is that this has resulted from historically low interest rate levels combined with increasing housing prices, which has meant that bad and doubtful debts have remained low allowing for increased profitability.
  - Looking forward for the banking sector, earnings per share (EPS) growth is still fairly weak in nature, capital imposts are still likely to happen and dividends aren't likely to grow. So given current trading levels, we believe they're fairly fully valued.
- After delivering weak results the prior reporting season, insurance companies delivered better returns this half after having increased insurance premiums across motor, home and CTP over the period.
- The retail sector had areas of weakness – such as discount department stores like Target and BigW, and larger department stores, including Myer, as they face increased competition. Grocery retailers such as Woolworths and Coles delivered fairly solid results.

KEY IMPLICATION FOR INVESTORS – IMPACT OF HIGHER INTEREST RATES

- We believe a key theme for all investors to consider now is – what will be the impact of higher interest rates on your portfolio?
- If you are holding real estate investment trusts (REITS), utilities and infrastructure – the valuations of companies in these sectors can be very sensitive to interest rates.
- We believe interest rates will continue to rise globally from here and as such there are clouds on the horizon of the housing market domestically.
- Interest rate rises can be beneficial for the banks, but they can also be a headwind. Our view is that this is what we may see here in Australia, given where we are in the cycle, with high payout ratios and high property valuations, coupled with the possibility that people struggle to make their mortgage payments in an increased interest rate environment.

STAND-OUT RESULTS: WOOLWORTHS

- Like-for-like sales growth on the supermarket business, and the margin on which they delivered it, were both much better than expected by the market and in line with our expectations.
- Balance sheet is in a very strong position – and even better than our expectations.
- We can see the possibility of Woolworths being debt-free in the next 12-18 months, which is quite unusual for a top twenty company.
- In addition, Suncorp delivered a very strong result and was a stand-out on the positive side.
- On the negative side, Telstra was a stand-out, delivering a poor result. The market is increasingly concerned with competition in their mobile business (which is a key revenue driver for them) so the sustainability of the dividend has come into question and we anticipate a tougher environment for Telstra.

MARKET VALUATIONS AND OPPORTUNITIES TODAY

- It is a tough environment and we believe the market is fairly fully valued.
- The market today is trading as a whole at 15½ times forward earnings, and the industrials ex-financials sector trading at 18 times – so our view is that earnings growth needs to pick up from here to start to justify current valuations.
- We've been building cash in our portfolios, given our strong buy-sell discipline at Perpetual, and a lot of our high quality companies have reached full valuations and we've been taking the opportunity to take some profits and sell down some of our holdings.
- At Perpetual, we believe it's our job to be cautious ahead of time, and point out where the risks to our investors might be.
- The best thing about equity investing is that the market is open every day, so there are always opportunities.
- In particular, there are some high quality industrial companies that have delivered poor results this season that we're looking at today for our investors.

Perpetual