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Corporates yet to embrace new world order

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The Dow sets the tone, but Australia's in a better position

FOR many industrial company chief executives, the profit season was a matter of being all dressed up but nowhere to go.

While their own house was in order with costs and debt down, and unwanted assets gone, growth had also disappeared.

To make matters worse, the collapse in corporate confidence on display in the cautious management chatter around the results highlights a possible mismatch between perceptions and reality.

Granted a company boss can be excused for not knowing what comes next, because the best brains in the world are still working that one out.

An unsatisfactory federal election in Australia with a lack of ideas and political courage, coming congressional elections in the US, mining taxes and the like are enough to magnify the uncertainties in local boardrooms.

But as Macquarie's Neale Goldston-Morris argues, Australian corporates are yet to embrace the fact the global order is changing. The world economy is expected to grow by 4 per cent this year, and not from traditional sources such as the US, Japan and Europe.

That's not exactly news, yet each day we still look to see what happened in the London and New York equity markets.

The local bourse gets its lead from the US, which rightly reacts to its own corporate news in a market that isn't exactly booming.

Boardrooms and stockbroker dealing desks talk up what happened to the Dow in their morning conferences, and the tone is set, but Australia's economic fortune is better than that, thanks to the Asian boom.

Australia didn't have a recession. Granted, the pace of growth is weak, but the corporate mindset has seemingly been set by the global laggards and not the new world order.

That mismatch is potentially damaging, because management and market attention is focused in the wrong area, which could lead to opportunities being lost.

The exceptions of course are obviously the big miners, whose fortunes are directly linked to Asia.

The resources sector was the only one to show any signs of revenue growth, but even it is showing signs of decline.

Corporate Australia has raised plenty of capital and cut costs, but that isn't the formula for growing the business.

Fairfax Media was one of many which demonstrated how it could bounce back with better revenue momentum, having reported a better than expected profit after a second half in which earnings before interest and tax rose 48 per cent on the back of a 6 per cent increase in revenue.

That is an impressive bounce by any measure, and if sustained it suggests the company has prepared a viable growth platform.

That can be said about many Australian industrial companies.

The big white hope is a pick-up in demand to drive revenue growth and a big boost to profits, but much of that is outside their control.

At some point corporate Australia has to take the initiative, because waiting for growth in the present global economy will take more patience than most shareholders have on offer.

The recent uptick in merger and acquisition activity in the US is a sign of carcasses being chewed over and companies trying to make their own growth.

The prevailing sentiment during the reporting season was caution, with management keen to downplay expectations for fear of raising hopes too high.

That is fine as an investor relations tool, but at some point management must take some risks.

Big banks went ex-growth in the last quarter, a function of the same slow recovery in evidence elsewhere. Business didn't want to use banks' products, with ANZ's Mike Smith for one bemoaning the fact that business loans were more for capital projects than working capital.

The resources sector was the star performer with 9.1 per cent revenue growth and increased margins, leading to expectations of 53 per cent earnings per share growth on Macquarie Equities figures.

As much as Australia prided itself on beating the financial crisis, the reality is that while private-sector GDP growth in the year just gone topped 5 per cent, earnings per share growth was just 2.2 per cent for all companies for the financial year.

One reason for the disparity was the capital raising boom in the 2009 year, which meant that while on Deutsche numbers June half profits rose by 22 per cent, earnings per share growth was more like 13 per cent in the half.

Shareholders are still paying for the capital raising boom, without getting much in the way of benefits just yet.

Hindsight is a wondrous thing. At the time boards of directors were issuing deeply discounted stock, they were obviously thinking the world as we know it was about to end.

At the same time, corporate Australia tightened its belt. Combined with strong cash generation, gearing has fallen to an average of 31.7 per cent for the market and 39.3 per cent for the industrial sector, which are well below the historical averages of 45 and 49 per cent, respectively.

Net interest costs are down 3.2 per cent and interest cover is running at a healthy 7.7 times for the market and 5.6 times for industrial stocks. In short, corporate balance sheets are in the best shape for decades.

Yet the extreme caution in management outlooks, which has driven downgrades to earnings forecasts, also tells you corporate Australia is not about to go on a spending binge.

Goldman Sachs figures show depreciation and amortisation increased by just 0.7 per cent in the June half — the lowest rate of growth since June 2004.

This tells you management has focused on core assets, getting rid of the rest as part of the de-risking process, and cut investment spending.

If the latest numbers are to be believed, surveys showing a 28 per cent increase in corporate investment this year suggest a rebound in depreciation and amortisation.

That assumes corporate Australia starts looking at the glass as being half full, as indeed some are.

It is not all doom and gloom and some chiefs have gone out of their way to talk up hope.

ANZ was the standout among the banks, in part because it has a strategy tied to Asia and growth.

Capital management activity is back on the table with buybacks from Woolies, CSL and Commonwealth Bank being signs that management at least realises that if there are no other obvious uses for capital, then shareholders should be looked after.

Dividends are not keeping pace with profit growth, but rose an impressive 11.4 per cent in the latest half, as more companies started to reinstate their dividend policies.

This, too, can be seen as a sign of more confidence.

Qantas and Virgin are also talking up growth as they prepare for a new round of competition with each other.

The accepted macro-economic view is that we will have a long, slow recovery, which suggests that we shouldn't expect too much from equity investments, with single-digit returns at best.

After corporate Australia prepared itself for a recession that didn't eventuate, the next 12 months will show whether it is prepared to seize its opportunities for growth.

STOCK PICKS FOR THE YEAR AHEAD

JOHAN CARLBERG
Alphinity Investment Management

PICKS

- ✔ BHP Billiton
- ✔ Rio Tinto
- ✔ Orica
- ✔ Leighton Holdings
- ✔ Adelaide Brighton

“Our investment process is to identify companies that have the potential to deliver stronger earnings than what the market is currently factoring in. In this respect it's hard to go past some of the resources names. I think the gap in growth rates between the Asian economies and the debt-laden economies of the west is only going to widen over the next several years. This will be good not only for the mining companies but also the companies building, supplying and maintaining the mines.”

DION HERSHAN
Goldman Sachs Asset Management

PICKS

- ✔ Supercheap Auto
- ✔ Cochlear
- ✔ ANZ
- ✔ Metcash

“Supercheap Auto's solid result highlighted the strength of its retail franchises and a good performance by management. Against a headwind of a high $A, Cochlear delivered 19% earnings growth and a successful launch of its new product, Nucleus 5, will underpin a period of earnings upgrades for the company. ANZ delivered the standout result in the banking sector with above-market credit growth, margin expansion combined with the positive benefit of declining provisions. Metcash delivered solid revenue growth, outstanding cost control and strong cashflows in a challenging retail environment.”

JOHN MURRAY
Perennial Value Management

PICKS

- ✔ Fletcher Building
- ✔ News Corporation
- ✔ Qantas
- ✔ AGL Energy

“There is still a great deal of economic uncertainty and it is difficult to accurately predict the timing of economic recovery. As a result, many investors are taking shelter in what they perceive to be the more defensive stocks and have bid their prices up to high levels. However, when activity inevitably picks up, the cyclical stocks will have terrific earnings leverage. AGL Energy will continue to grow its profits on the back of a very good result this year and is a leading contender to buy into the privatisation of the NSW Electricity assets.”

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IAN HARDING
WaveStone Capital

PICKS

✔ Adelaide Brighton
✔ Carsales.com
✔ News Corporation

“After initially guiding investors to a ‘modest decline’ in full year 2010 net profit in February, AdBri posted a 57% growth in the first-half earnings. The latest guidance is for about a 15%+ full-year result which could now be seen as conservative. Rapid demand growth and tight industry structure have allowed the company to raise prices to cover input cost inflation. ABC’s favourable geographic and industry exposure together with strong cement sales driven by infrastructure projects in South Australia and the resources sector in Western Australia support a positive outlook. Carsales demonstrated impressive leverage with EBITDA margin expansion of 7% to 52%. The result was driven by private sales and the corporate display advertising business which benefited from a rebound in media spend. News Corp demonstrated powerful growth from the Cable Networks segment where operating income grew 32%. Confident outlook commentary indicated an accelerating advertising market and FY11 guidance surprised the market on the upside.”