Reporting season signals market on the move

Themes are emerging as companies come clean on their efforts

JAMES KIRBY

EVERY results season matters, but the interim reporting season that has filled our business pages over the past fortnight was absolutely crucial to investors because last year's 20 per cent run-up in the ASX 200 was heavily predicated on the "earnings coming through" — and, by and large, that's just what has happened.

But behind these numbers there are some important patterns which just about everyone with an interest in the sharemarket should digest.

Understandably, the coverage of the results focused on the surprises — that is, the results that come in higher than we might have expected or, alternatively, the figures that disappointed investors. But what really matters is the cumulative effect the results season will have on the market.

It's not easy to accurately gauge this effect so soon — there are still weeks to go in terms of results announcements — but noting the ASX 200 has lifted by 4.1 per cent since the start of this month tells you the desired momentum is upon us.

Behind the headlines there are six key aspects of this results season every investor should note:

1. The bellwether stocks came in better than the market expected. If the Australian market is heavily underpinned by two sectors — banks and mining — then those sectors in turn are underpinned by the Commonwealth Bank (CBA), the 10th biggest bank in the world, and BHP Billiton, the world's biggest miner.

CBA romped home with a 14 per cent lift in profits — better than consensus. Better still, the return on equity at the bank was a handsome 18 per cent. Compare that with the 8 per cent achieved by Bendigo Bank and you get a clear idea why bigger is better in local banking.

BHP, on the other hand, brought in roughly $1bn more than the market was expecting thanks to cost-cutting and a productivity focus.

These two results set the tone for the entire market and they were convincingly positive.

2. Market leaders pushed hard to lift dividends — even without a profit lift.

The "hunt for yield" is the main game for local retail investors and every single major company is now trying to satisfy the trend. Telstra lifted its dividend even though there are distinct concerns whether future earnings will properly justify this move. More dramatically, two key companies lifted dividends at a higher rate than profits — Wesfarmers profits lifted by 9 per cent but the dividend lifted by 10.4 per cent. If you think that is a concern, consider that Suncorp announced a drop in profits of 4.5 per cent but a lift in dividends of 40 per cent.

In summary, blue-chip chief executives realise that dividend yield may override the desire for actual growth in the local market and they are prepared to sign off improved dividends, whether the immediate numbers justify the move or not. That's all fine if the earnings improve in the months ahead, but if they don't, companies will be stuck with higher dividend payout ratios and slow growth, a cocktail that will sour quickly if rivals show real earnings growth on the back of investments in the company rather than allocations to dividends.

3. Overall, there were few disappointments across the market. Roughly one in five companies that have reported to date have missed expectations, a reasonably low rate considering we have an economy growing at below trend. Where significant stocks seriously disappointed the market there were often very particular explanations: Coca-Cola Amatil reported an 86 per cent downturn in profits almost entirely due to restructuring costs at the high-profile SPC Ardmona fruit processing facility in Victoria.

AARON FRANCIS

The companies that disappointed investors had good reason. CCA saw profits slide due to restructuring efforts at SPC Ardmona

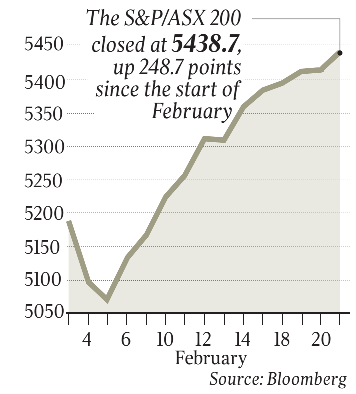
Interestingly, the disappointments, when they came, were not common to any one sector, with the possible exceptions of airlines (though those poor numbers were well flagged).

4. The miners beat the gloom. There are, of course, the three big miners — BHP, Rio Tinto and Fortescue — and there is daylight between this group and the other 500 or so mining stocks that dot the market.

However, the big three all came in better than expected and this feeds nicely into the theory that investments in miners are now at what is surely the bottom of the cycle and they will pay handsomely in the longer term.

BHP's new chief, Andrew Mackenzie, managed to lift underlying profit by 31 per cent. There were weak spots (such as petroleum) but a leaner and meaner BHP is clearly kicking goals. Likewise, Rio, under its new chief Sam Walsh, increased profits by 10 per cent and, usefully, it was not just from iron ore. Rio has, after all, become a one-metal company in terms of profits over the past two years. Profits also emerged at the aluminium division, which had been seen as a lead weight (sorry!) at the miner for some time.

It was, however, the endlessly inventive iron ore operator Fortescue that shot the lights out with a net profit 2.5 times higher than



the previous corresponding period. In common with Rio, an element of this profit increase came from reducing debt costs; nonetheless, the miner once again defied doomsayers. What's more, extending its reputation as a company that always raises its own ambitions, Fortescue followed the better than expected performance with announcements it would take a substantial bet on capacity expansion in the coming months.

5. Consumer stocks outperformed the entire market.

Retailing is a key part of the Australian stockmarket and it is highly cyclic. For the past few years it has been a nightmare, with problems on every front and valuations falling to the point that clear confidence in the sector was shot. Well, that was last year's news as, remarkably, over the past 12 months consumer discretionary stocks, especially retail, came in with an average total return of 38 per cent — more than triple the wider market's total return of 10.5 per cent.

Within this dramatic rebound in the retail sector there are companies that, if not quite back from the dead, are back from a very dark place indeed.

Two sterling examples are Country Road and Webjet, which lifted 44 per cent and 26 per cent respectively on the day their results were announced. In both cases the stock price rebounds were underpinned by strong results. There are exceptions here, of course, and plenty of them. Dick Smith did not quite match its promise, and The Reject Shop fell behind expectations. Nevertheless, life has returned to this moribund sector.

6. Even failures got rewarded.

Perhaps this is the most important development of all: even with flat or poor results "Mr Market" is in such a benevolent mood that mediocre top-line results have been ignored as bullish comments from management on the future are taken up with gusto.

Two strong examples here are the building products company Boral and the rail services company Aurizon (previously known as Queensland Rail).

Boral has a new chief executive in Mike Kane and the group is well advanced in a total makeover, but the group actually reported a net loss of $25m for the second year in row. Investors cast this news concerning Boral's first half aside as imaginations were fired up at the thought of a major building company reforming itself amid a looming home building recovery.

An even stronger example of the phenomenon was the half-year result at Aurizon, which was 40 per cent lower than the corresponding period a year earlier. It was dragged down by one-off impairment charges to the company's trains and a whopping $50m strategic review.

Never mind. Aurizon chief executive Lance Hockridge said coal haulage volumes were set to improve in the second half and the shares hit a high on the same day.

All in all it's been a solid reporting season and, though there will no doubt be some negative upsets in the days ahead, the mood is set: good results get rewards, poor results are generally accepted as long as the outlook comments from management are positive. The next part of the cycle demands more input from revenue gains than cost savings, but so far, so good.

James Kirby is managing editor of the Eureka Report. This article is part of the It's Time series in Eureka Report, focusing on new opportunities for investors this year.

Share buybacks allow investors to scoop up a bigger stake

ROGER MONTGOMERY

THE reporting season is revealing a conga line of companies that are exceeding analysts' expectations. But does that make the company better or the analysts worse?

For what it's worth, while interest rates remain low and corporate profits rise, the stockmarket should do OK. Your only job is to ensure you focus on quality businesses — those with bright long-term prospects — and only buy them when good value is evident.

As companies exceed forecasts with increasing cashflows, investors this year may also benefit from a trend towards paying more dividends and from share buybacks. And while dividends are well understood, buybacks are perhaps a little less so.

In the week just gone, everyone seemed very excited when BHP Billiton announced a first-half profit that exceeded analysts' expectations by almost $1 billion. Analysts had expected a $6.9bn profit but BHP reported first-half income of almost $7.8bn.

Analysts and commentators waxed lyrical about a dividend "bonanza" and the bringing forward of a share buyback.

And with the share price still where it was 6½ years ago (in July 2007), is the company making the right decision buying back its stock?

Buybacks for BHP would obviously be dependent on the price of iron ore and must compete with other projects the company claims can deliver 20 per cent returns on equity.

Companies that buy back shares are doing the right thing from a shareholder perspective. Acquisitive companies, if disciplined, should always compare the purchase of another business to the purchase of their own shares. Sometimes their shares may be cheaper. By repurchasing shares, the company can permanently increase its return on equity and, depending on the price paid for the shares, increase its value.

When a company uses its retained earnings to repurchase its own shares, it not only increases your percentage ownership of the company, it gives you a tax advantage. Many investors have mentioned to me that rather than see a company buy back its shares, they prefer to receive a dividend and decide whether to buy more shares themselves.

AFP

BHP Billiton is bringing forward a share buyback

Others have asked whether a dividend reinvestment plan achieves the same thing.

Both are less desirable, however, because both involve the recipient usually receiving a tax liability along with the dividend.

When the company does the buying on your behalf, you may be a lot better off. More often than not, management is reluctant to engage in buybacks, because they can reduce the size of the balance sheet. However, when buybacks are conducted at prices below intrinsic value, they increase the value of the company for remaining shareholders.

Let's suppose that a company has equity or a book value of $100 million and 100 million shares on issue, and there are 1000 shareholders, each owning 100,000 shares. Now suppose that half the shareholders want out and band together to suggest the company offer to buy back their 50 million shares on the market for $40m and then cancel the shares.

The loyal 500 shareholders who remain will now hold all the shares of the company — 50 million shares and equity of $60m. This is a substantial improvement on the previous position where they owned 50 million shares worth $50m. By taking advantage of a low price, they have increased their own worth.

When a company repurchases its shares at prices that are lower than the equity value of the company, it can increase the value of the business to its remaining shareholders. During the global financial crisis, however, companies were doing precisely the reverse.

A company that sells high and buys low will do the same financially for its shareholders as it would do for itself by engaging in such activity. In 2009, Australian company CSL raised capital of $36.75 per share in anticipation of an acquisition. Ultimately, US regulators blocked that purchase and CSL elected to return the capital to its shareholders by repurchasing its own shares on the market, paying about $31.80.

But just as you personally will suffer if you buy shares for more than they are worth, shareholders of a company whose management engage in the same practice will suffer equally. When a company buys back shares without regard to the value of those shares and pays too much, it can destroy value for remaining shareholders.

For BHP shareholders, there is another benefit of repurchases that might be less subject to precise measurement but is just as important. Buying back shares below market value demonstrates management prefers actions that enhance the wealth of shareholders, rather than actions that expand "management's domain".

We may soon find out the true ambitions and motivations of BHP's management.

Roger Montgomery is the founder of Montgomery Investment Management.

Opportunity missed but ERM figures show it's a winner

UNDER THE RADAR

RICHARD HEMMING

WHEN you are small you have to ruffle some feathers to get noticed, and this is certainly the case with Australia's fastest-growing energy services provider, ERM Power.

The company is seen by many in the investment community as an upstart following its recent foray into the world of baseload power generation. Earlier this month it emerged that the domestic giant AGL (market cap $8.9 billion) trumped ERM in its efforts to secure the state-owned power company Macquarie Generation, which supplies NSW with about 26 per cent of its electricity.

AGL's winning bid was $1.5bn and the deal could yet be blocked by the Australian Competition & Consumer Commission because of concerns it will reduce competition and push up prices.

ERM managing director Philip St Baker must have been annoyed when repeatedly asked by *The AFR* whether his company was "too small to be able to compete with the big guys". He responded: "No, I don't buy that. We've built more power stations than Origin and AGL in the past decade. We've raised billions of dollars from all the major banks."

Investors such as Heath Behncke of Sigma Funds Management agree: "Philip's father (Trevor) started the business, which has done more power development than any other company in Australia."

The company listed in late 2010 having raised $100 million in order to take advantage of the privatisation of power utilities. Its issue price was $1.75 a share, giving it then a market capitalisation of just under $280m. Fast-forward three years and its shares are $2.38 and its market cap is $566m.

Underlying ERM is the management's 30-plus years' experience in the electricity and power markets. The company was founded in 1980 by Trevor St Baker, who owns 41.9 per cent. Prior to ERM, Trevor was a government electricity planner. His company developed and ran six gas-fired power stations before selling four. ERM's key assets now are the Oakey power station in Queensland, and the Neerabup station in Western Australia.

Since listing, ERM has successfully transformed itself from an electricity generation business to one powered by electricity retailing — buying electricity from power suppliers and selling it to users. ERM has grown its share of the market from zero to 7.5 per cent in the past six years and is the fourth biggest retailer in the country. ERM is gaining market share quickly because of its superior client service compared with bigger and more cumbersome competitors. Its biggest market is in the commerce and industrial space and it has just started attacking the small and medium business segment. There are much bigger risks in the SME segment, but much bigger profit margins.

Although AGL's share price has spiked and ERM's is in the doldrums, on balance we think missing out on MacGen is a positive for ERM because it won't be undertaking a $300m-plus rights issue.

We also hear that ERM's bid was $300m lower, which means that St Baker's team wasn't willing to overpay for the assets, which are powered by thermal coal.

The stock is outstanding value, with its Oakey power station being worth about $300m, plus it has close to $100m in cash and its retail business is generating $50m in operational earnings. Oh, and it delivers dividends too, trading on a yield of more than 5 per cent (AGL's is 4 per cent).

Richard Hemming edits www.undertheradarreport.com.au The author does not own shares in any of the stocks mentioned.