Hold the celebrations

The benefits of a falling dollar may be overstated, writes Roger Montgomery

A **NUMBER OF STOCKS IN THE** Australian market, including Amcor, ResMed, Brambles, CSL and James Hardie have benefited from the Australian dollar having fallen more than 30% from its high of just over $US1.10 in July 2011 to US75¢ at present.

Movements in the $A have an impact on company earnings in a number of ways. The main two are through "translation" and "transactions" exposure.

Translation exposure refers to companies with overseas operations. These companies have both revenue and costs denominated in foreign currencies. The impact of a fall in the $A will generally increase the $A profit generated by the business in line with revenue and costs.

Transactions exposure generally refers to companies that export products from one country to another. As a result, a proportion of the company's costs will be denominated in a different currency from its revenues. This can lead to significant movements in product margins as exchange rates fluctuate. Resources companies and other exporters such as wine producers have high levels of transactional exposure to the $A.

Given changes in the $A impact on both revenue and margin for companies with transactions exposure, their earnings tend to be far more significantly affected by exchange rate movements.

The market will generally anticipate the impact of recent movements in the $A on company earnings. However, projections tend to use simplistic sensitivity ratios. The actual impact is generally more difficult to estimate due to secondary impacts, particularly when underlying product pricing is less visible.

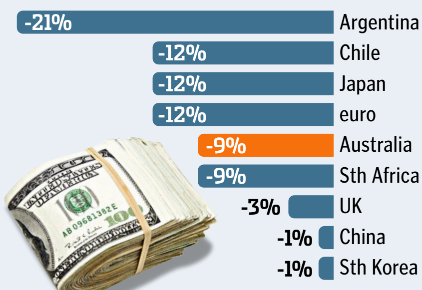
The wine industry is a typical example of where simplistic earnings sensitivities can overstate the benefit a fall in the $A will generate for company's earnings.

Wine exports are generally priced in the currency of the destination market. Movements in local currency pricing will be driven by the market power of customers and the activity of competitors.

The fall in the $A should lead to a significant increase in gross margins for Australian wine producers due to the lift it generates in unit revenue in key export markets (the US and UK) while leaving unit costs unaffected.

Treasury Wine Estates indicated in its 2014 results that a 10% shift in the $A against the US dollar and British pound would affect group earnings before interest and tax (EBIT) by just more than 20%.

Change in average exchange rate against the $US for the 12 months to June 2015



SOURCE: BLOOMBERG

But it must be remembered that wine companies such as Treasury sell into highly concentrated retail markets. And other wine-producing countries are also benefiting from depreciating currencies, namely Chile, South Africa and Argentina. The average $A/$US has fallen 9% in the 12 months to June 2015, compared with 12% for the Chilean peso, 21% for the Argentine peso and 9% for the South African rand.

So the Australian industry has not gained a unit cost advantage relative to a large proportion of its competitor base.

Retailers are also able to calculate the benefit of the falling $A to the producer, providing them with a strong argument in negotiating reductions in local product prices. The increased competitiveness of producers from Chile, Argentina and South Africa, along with other local producers, provides retailers with leverage in negotiations.

As a result, at least some of the transactional benefits from the falling $A are likely to be competed away. In its trading update in late May, Australian Vintage noted that the margin benefit from the lower $A against the pound was offset by margin pressure from UK customers.

For companies with translation exposure, the key to determining the net impact on margins is determining whether the business has competitors that have cost bases denominated in other countries.

The flipside – and potentially underappreciated benefit – is for Australian companies focused on the domestic market and with local cost bases, that primarily compete with imports. While the falling $A might not have an immediate impact on competitor pricing and activity, over time the willingness of import competition to absorb the impact of the weaker $A is likely to dissipate. This is likely to be the next leg of the $A depreciation story.

Roger Montgomery is founder and investment head at the Montgomery Fund. For his book Value.Able, see rogermontgomery.com.