Budget boosters fading

Business 'as usual' as honeymoon wears off

JASON CADDEN
CONFIDENCE

BUSINESS and consumer confidence have fallen from their post-Federal Budget highs, weighed down by weakness in the mining sector.

The National Australia Bank business confidence index dropped to four points in July, from eight points in June.

NAB said that while confidence had eased in most industries, much of the fall was in mining and construction amid worries about weaker Chinese economic growth.

Meanwhile the weekly ANZ-Roy Morgan consumer confidence index fell 0.4 per cent to 112.5 in the first full week of August, after gaining 5.5 percentage points across the previous three weeks.

CommSec chief economist Craig James said it was inevitable that business and consumer confidence would fall after enjoying a honeymoon from a business-friendly Budget and the Reserve Bank's May interest rate cut.

"Now it's back to normal," Mr James said. "Business confidence and conditions are consistent with average levels over the past four or five years. Consumer confidence likewise."

Mr James said the falling Australian dollar and the RBA's prediction that the unemployment rate would, or already has, peaked below 6.5 per cent are also encouraging signs.

NAB's business conditions index also fell in July, down four points to six points, with gains in the services sector unable to overcome mixed readings in other areas.

NAB said that looking past the month-to-month volatility, business confidence is still holding up well and trading and profitability conditions remain elevated.

JP Morgan economist Ben Jarman said that some of the business conditions measures show that things are going well for the non-mining sectors of the economy. "The services sector is still looking very perky, consistent with other indicators, and that sector is very influential for employment outcomes," he said.

"The NAB survey reports on the labour market in July were mixed. The employment intentions index slipped two points, returning to its average of the first half of 2015.

"But that level has been sufficient to hold the unemployment rate relatively steady, given the moderation in labour supply growth."

NAB's outlook for the Australian economy is marginally stronger than it was a month ago, and now forecasts gross domestic product to grow by 2.8 per cent in 2015-16 and 3.2 per cent in 2016-17.

The bank expects the central bank to keep the cash rate unchanged at its record low of 2 per cent until at least late next year, and that it's more likely to cut rather than hike until a recovery in the non-mining parts of the economy is fully under way.

AAP

Megadeal? Watch this aerospace

MANUFACTURING

AMERICAN investment guru Warren Buffett's Berkshire Hathaway will spend $US37.2 billion ($50.2 billion) to snap up a parts supplier to the aerospace industry.

The deal for Portland, Oregon-based Precision Castparts will mark the biggest outlay for a single entity in Berkshire's 50-year history.

It shades the conglomerate's 2010 purchase of rail operator Burlington Northern Santa Fe in a cash-and-debt deal valued at $US36.5 billion.

The deal is subject to approval by Precision shareholders and regulators and is expected to be completed in the first quarter of 2016.

"I've admired Precision's operation for a long time. For good reasons, it is the supplier of choice for the world's aerospace industry, one of the largest sources of American exports," Mr Buffett, who is Berkshire's chairman and chief executive, said in a statement.

Mr Buffett, 84, is the world's third richest person.

Investment in animal care has once again become cost-effective for Greencross, which has posted a $19.1 million net profit.

Vet group purring with healthier kitty

PET CARE

PET care specialist Greencross has swung to profit following solid sales growth and an expansion of its veterinary clinics and retail stores.

Greencross says it expects strong revenue and earnings growth in the year ahead on the back of a solid 2015 financial year.

It has posted a net profit of $19.1 million for the 12 months to June 30, compared to the previous year's loss of $127.8 million. This has pleased investors, who drove the group's share price up 86c, or 14.9 per cent, to $6.84.

Greencross opened 65 new retail outlets to take its total to 200 across Australia and New Zealand, and added 21 veterinary clinics to expand its clinic numbers to 132.

The group says it has completed the acquisition of 42 City Farmers pet care stores in Western Australia on time and budget. Chief executive Jeffrey David says Greencross will increase its 8 per cent share of the $8.7 billion Australasian pet care market to 20 per cent.

"It was a big year for growth in outlet numbers," Mr David said. He said total revenue for the current financial year was up 19 per cent so far.

BATTERED BRADKEN EYES TIE-UP

MINING SERVICES

MINING services group Bradken is preparing for a turnaround in the sector as it weighs up a merger proposal in the wake of a $240 million loss.

Bradken, which has undergone a major restructure and asset writedowns, has until the end of the month to decide whether to merge with Chilean outfit Magotteaux Group.

The company's revenue has fallen sharply after it merged four of its businesses, closed underperforming manufacturing facilities and recorded writedowns related to a drop in demand.

Managing director Brian Hodges said the restructure of manufacturing was close to completion and had positioned the company to gain volume when the market improved.

Bradken and Magotteaux Group have until August 29 to decide on the merger.

Shares in Bradken added 1.4 per cent to $1.125.

Big four have been making hay while regulator shines

THE SHORT CUT
with ANDREW MACKEN

IMAGINE there is a very successful company today, called "Seebee Hay", that sold widgets at an attractive profit.

Not only are Seebee Hay's profits high, but the amount of shareholders' equity that Seebee Hay requires to sustain and grow its business is low — thereby resulting in a high return on equity, one of the best indicators of business quality we have.

Seebee Hay has done particularly well over recent years: fortunately demand for Seebee Hay's widgets have been growing very strongly; and, on top of a somewhat fixed cost base, operating leverage has resulted in expanded profit margins and strong profit growth.

Seebee Hay is listed on the local stock exchange which means that investors have been able to own its shares and participate in the success of the company.

The combination of strong profit growth and minimal capital requirements has resulted in significant excess capital being distributed back to shareholders in the form of dividends.

Now imagine that, all of a sudden, Seebee Hay's local regulator changes the rules on the company, which results in a 40 per cent decline in the return on equity that the company can achieve on each widget sold.

Furthermore, Seebee Hay has been selling so many widgets in recent years that demand growth is now starting to slow.

Against this backdrop would you buy shares in Seebee Hay today?

Seebee Hay can arguably be characterised by any one of the four major Australian banks; and the widgets they sell, of course, are Australian residential mortgages.

In relation to the major banks, last month the Australian Prudential Regulation Authority made the following statement which equates to a very significant change in the rules: "The average risk weight on Australian residential mortgage exposures will increase from approximately 16 per cent to at least 25 per cent."

This is bank-speak for the following: the return-on-equity of Australian residential mortgages will fall by around 40 per cent for the major banks, all else being equal.

This decline will manifest itself through higher equity capital requirements (the denominator in the return-on-equity ratio) rather than lower profits (the numerator).

And we have already started to see this in action. In July, National Australia Bank effected a rights issue in part to "absorb potential regulatory changes"; while in August, Australia and New Zealand Banking Group raised $3 billion in equity capital "following the introduction of APRA's revised risk weightings".

Such equity capital raisings are basically the reverse of dividends — instead of distributing capital to shareholders, banks are sourcing new additional capital from shareholders.

Naturally, this is negative for total shareholder returns.

The situation has clearly changed for the major banks: regulations are becoming more punitive, the outlook for credit growth is unclear and so operating leverage may not be as conducive to margin expansion in the future as it has been in the past.

On the other hand, it's not all bad.

Whichever way you cut it, Australia's major banks appear to operate in a very co-operative market structure.

And the big four will almost certainly enjoy some form of taxpayer guarantee for the rest of time.

These are attractive characteristics which will help the major banks weather the storm they currently face.

Andrew Macken is portfolio manager at Montgomery Global Fund