THE SHORT CUT

with ANDREW MACKEN

BLACK CLOUD HANGS OVER AURIZON

WHILE many Australians were knocking off for the Christmas holiday period, one company provided the ASX with an ugly update of its current operational performance and expected profitability.

On December 23, Aurizon Holdings, the rail company that hauls coal, iron ore and other freight, told the market its crucial coal volumes and earnings would likely decline this financial year.

The company also informed the market of an impairment charge in the order of $215 million to $240 million for the six months to December 31, 2015.

The disappointing news sent the stock down 12 per cent on the day, capping off a bad month for shareholders.

The stock price fell by more than 21 per cent in December. This is arguably the first major blemish for what has otherwise been somewhat of a “market darling”.

Listing on the ASX in November 2010 at $2.55 per share, the former wholly government-owned rail freight company, then known as QR National, went on to deliver investors a five-year average annual return north of 20 per cent per annum.

The model to deliver shareholders such stellar returns was fairly straightforward: growing haulage volumes would lead to growing revenues.

Growing revenues on top of a fairly fixed (and reducing) cost base would result in expanding profit margins and rapidly growing earnings.

Combine these dynamics with increased borrowings, and the ability to pay dividends and buy back stock would be enormous.

In an income-loving market such as Australia, this was the perfect model that was adored by investors and sell-side research analysts alike.

Yet in December, the wheels started to fall off.

Aurizon downgraded its expected coal haulage volumes by 3 to 4 per cent from its guidance from four months earlier. The company noted “there is a higher level of uncertainty over second-half volumes than in recent years”.

Falling haulage volumes will likely drive falling revenues; and this is bad news for such a highly capital-intensive, largely fixed-cost business.

What essentially happens in such a scenario is that the previously-positive effects of high operating and financial leverage go into reverse

In the same way that growing revenues were driving expanding profit margins, growing earnings and increasing capital returns to shareholders — declining revenues will now likely drive contracting profit margins, declining earnings and fewer capital returns.

The company has already guided to earnings before interest and tax of $390 million to $410 million for the half year to December 31.

This is down about 18 per cent from the same period in the previous year. And while the company will surely continue its impressive cost-reduction program, this will unlikely be enough to counter declining revenues.

Aurizon even noted as much: “While the benefits of ongoing operational improvements continue to be realised, these have been offset by the reduced above-rail coal volumes.”

So the real question for investors to answer is this: will coal haulage volumes continue to fall? That’s not an easy question to answer.

With the world in a clear coal oversupply and coal demand growth continuing to slow, one could suggest that there is more pain to come.

ANDREW MACKEN IS A PORTFOLIO MANAGER WITH MONTGOMERY GLOBAL INVESTMENT

China’s woes weighing on consumers

THE ECONOMY

AUSTRALIAN consumers have become more cautious as fears about China’s growth prospects and its battered share prices reverberate through global financial markets.

The ANZ-Roy Morgan consumer confidence index fell 1.9 points for the week ending January 10, more than retracing the 0.8 per cent gain recorded the previous week. The drop coincided with turmoil on global equity markets, which were shaken by fears about China’s economy and government moves to ease steep falls on its share markets.

Australian consumers reacted by becoming worried about personal finances, ANZ chief economist Warren Hogan said.

The survey’s subindex on personal finances dropped almost 10 points, the biggest fall since March 2012. Consumers’ views about their future financial position also deteriorated.

That subindex has fallen 5.8 points in the past three weeks and is now below its long-run average. “(But) overall, consumer confidence remains above its long-run average and well above the levels seen for much of the last two years,” Mr Hogan said.

CommSec chief economist Craig James said people had become more circumspect as the Aussie dollar had plummeted in response to China’s woes. “Clearly, consumers have become more alert, but we really can’t say they’ve become alarmed,” he said.

Oil crunch to fuel asset sales

KIM CHRISTIAN
ENERGY

AUSTRALIA’S struggling oil and gas producers are expected to put more assets on the market this year as oil prices hit fresh 12-year lows.

But analysts say local companies will struggle to find buyers as oil prices continue to fall, putting further pressure on already weak balance sheets.

US crude prices fell 4.3 per cent yesterday to $US31.72 a barrel, while benchmark Brent dropped 5 per cent to $US31.83 a barrel amid fears over slowing demand in China and a growing inventory glut.

IG market analyst Angus Nicholson said renewed fears about China had driven the overnight sell-off and there could be further significant share price falls among Australia’s oil and gas players, which were struggling to break even.

“Future asset sales are more likely,” Mr Nicholson said.

“The last thing any prospective M&A buyer wants to see is a further drop in prices.

“A lot of people will be sitting on the sidelines because at the moment it’s very much in freefall. Heading down to lows of $US20 level is still very possible.”

Companies such as Santos, Origin, AWE and Drillsearch could come under more pressure if prices remained around $US30 a barrel for six months, he said. Mr Nicholson said merger and acquisition activity had all but disappeared with the recent fall in oil prices.

Fat Prophets analyst David Lennox said company cost cutting would continue ahead of a painful financial reporting season next month.

“If the oil price stays this low there will be significant writedowns of values in the balance sheets,” Mr Lennox said. Virtually all of Australia’s oil and gas companies were struggling at current prices.

“Until we see significant production cuts it’s going to be a continuation of the same,” Mr Lennox said.

Forecasts of slowing global growth had come as a “double whammy” following the 2015 supply surplus, he said.

Among heavy falls yesterday, Santos shares were down 8 per cent to $2.95 and Origin Energy 4.7 per cent to $4.05.

Shares in Beach Energy were 10.5 per cent lower at 38.5c after it appointed Oil Search executive Matthew Kay as its new chief executive.

It comes days after Origin Energy’s $24.7 billion Australia Pacific Liquefied Natural Gas project shipped its first LNG cargo to Asia.

AAP

Falls in crude oil prices will pressure producers to sell assets this year, analysts say.

MARKET WRAP

COAL MINER A DIAMOND ON ROUGH DAY

WHITEHAVEN Coal says it is on track to achieve its upgraded full-year forecast after sharply lifting its output and sales in the past quarter.

The miner’s production of saleable coal was 4.95 million tonnes for the three months to December — more than double the tally the same period a year earlier.

It was helped by a ramp up at a new mine and record shipments from another.

Coal sales also jumped 67 per cent jump to 4.9 million tonnes. **Whitehaven** nonetheless closed down 3.5c at 58.5c.

It came as the Australian share market closed in negative territory for its eighth-consecutive session.

After enjoying a rebound during the morning session, the Australian bourse gave up its gains to finish slightly lower amid concerns oil prices could slide under $US30 a barrel after hitting a 12-year low overnight.

The benchmark ASX 200 index closed down 7.1 points, or 0.1 per cent, at 4925.1 points, while the broader All Ordinaries index was down 8.5 points, or 0.2 per cent, at 4982.2 points.

“There are some concerns that we could see further slides, and so the energy stocks were the worst performing today,” CMC Markets chief strategist Michael McCarthy said.

Mining heavyweights **BHP Billiton** fell 54c to $15.01, **Rio Tinto** dropped 14c or 3.3 per cent, to $39.15, and **Fortescue Metals** dropped 5.5c to $15.85. Oil and gas producer **Woodside Petroleum** 55c to $27.08.

Building materials group **James Hardie** closed lower after reporting annual earnings would be up on last year. The stock finished down 11c or 0.7 per cent, to $15.72.

Among the major banks, the **Commonwealth Bank** rose 75c to $79.39, **National Australia Bank** fell 7c to $27.35, **ANZ** descended 10c to $25.05, and **Westpac** rose 26c to $30.82. Gold was trading at $US1095.80 per fine ounce, down $US9.30.