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Reporting season dominated by cost pressures and high P/E

- ***What does this mean for investors? –***

The current Australian reporting season has largely overlooked the fundamentals, instead rewarding stocks with high P/E ratios regardless of lackluster earnings, according to the active equity specialist Martin Currie, an affiliate of Legg Mason, one of the world's largest funds management groups.

Martin Currie Australia, Chief Investment Officer, Reece Birtles says that despite the positive economic backdrop, revenue environment and underlying fundamentals of Australian companies, disappointingly, EPS revisions post-result have had the worst negative skew in 10 years, although the aggregate downgrade has been mild.

"There appears to be no strong macro or sectorial theme to explain the direction of EPS revisions, but the nature of the earnings revisions is quite clear – cost pressures and falling margins, with operating expenditure and capital expenditure increasing after years of restraint and cost cutting.

"There is a clear dichotomy in the Australian market, split between disdain for increased investment spend amongst stable, profitable companies, but reward for high P/E stocks doing the same thing – even though increased investment should result in better bottom line growth in the long run for both sets of companies," he notes.

Based on over 150 company management meetings that Martin Currie Australia analysts have conducted during this reporting season; the key cost and investment pressure themes can be summarised as follows:

- Resource sector: strong recent cashflow is burning a hole in resource company pockets, so we are starting to see them loosen the purse strings to replenish under-invested mines.
- Industrials sector: raw material cost pressure (e.g. oil products, electricity) is too significant to be able to pass onto customers without absorbing some costs into the P&L.
- Utilities sector: government intervention is putting pressure on prices and ageing plants require more capex.
- Real estate sector: capitalisation rates are too low to buy developed assets, so REITs are having to develop new assets on their balance sheets.
- Services in general: wage cost pressure is key. We have heard stories of companies having to increase wages by high-single digits to retain professional services staff, especially in construction, infrastructure and mining (quite contrary to ABS wages data).
- High P/E stocks in general: we are seeing these companies investing to grow.

Birtles says that high P/E (and high momentum) stocks appear to be the 'flavour du jour' this reporting season.

"Top quintile stocks by P/E ratio have had flat revenue revisions and negative 1% EPS revision, essentially the same as the lower P/E stocks. However, despite less than stellar fundamental results the market re-rated these names +7% over reporting season. There was no such special treatment for the rest of the market.

“We see this disconnect in the P/E re-rate as the biggest driver of performance over the reporting season. This situation has left high P/E stocks looking their most expensive in 15 years. The only reason Value spreads are not even wider is that low P/E stocks are not as cheap as they were back in 2009.

“The result has been to generate far more share price variance between the best and worst companies relative to earnings revisions variance.

“As value investors, we see these short-term disconnects as opportunities for fundamentally driven research. In the long-term, we believe that fundamental investors may be able to gain an advantage by investing in attractively valued companies with strong long-term earnings power, good free cashflow and disciplined capital investment – rather than just paying up for what is the flavour of the month,” says Birtles.

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About Legg Mason
Guided by a mission of ‘Investing to Improve Lives™, Legg Mason helps investors globally achieve better financial outcomes by expanding choice across investment strategies, vehicles and investor access through independent investment managers with diverse expertise in equity, fixed income, alternative and liquidity investments. Legg Mason’s assets under management are AUD$1 trillion as at 30 June 2018.

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Australia Facts:
• Legg Mason’s Australian business was established in 1954
• Assets Under Management (AUM) in Australia are AUD$55 billion as at 30 June 2018 (Source: Rainmaker Data. Consists of AUM managed in Australia for Australian and offshore investors and AUM managed offshore for Australian investors)
• Legg Mason Australia was awarded the Money Management/Lonsec Fund Manager of the Year in 2015, 2017 and 2018.

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About Martin Currie
Martin Currie is an independent investment affiliate of Legg Mason, a global asset management firm.

Martin Currie is an active equity specialist, driven by investment expertise and focused on managing money for a wide range of global clients. Its approach to investing is simple: it focuses on companies. The integrated investment floor seeks out those companies it believes have the fundamentals to deliver material outperformance on a medium to long-term basis. Once identified, these ideas are moulded into well-balanced portfolios. The firm’s approach to portfolio construction reduces and controls macro-factor sensitivity, aiming for client portfolios to derive maximum value from stock insights and for returns to be delivered in a predictable and sustainable fashion.

- Established 1881
- Head office Edinburgh, Scotland
- Martin Currie Australia team has 35+ years of experience managing Australian equities
- Total funds managed as at 30 June 2018: AUD$23 billion

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