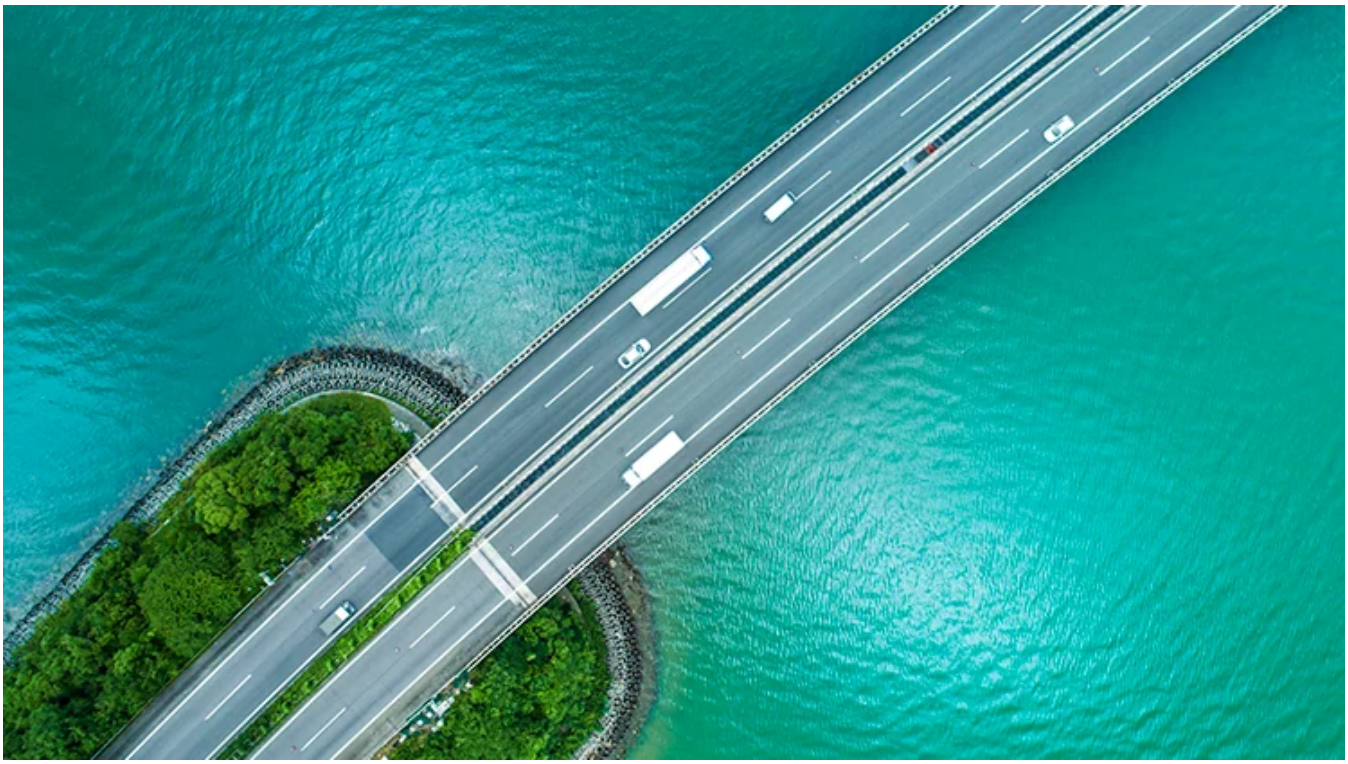
Reporting season puts spotlight on balance sheets

By Vince Pezzullo

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Perpetual Asset Management Australia's Head of Equities Vince Pezzullo offers a top-down overview of how the recent reporting season played out.

In terms of broad aggregates, revenue growth was a feature of the recent earnings season, mostly due to inflation being pushed through, but there was little else for the market to be enthused by. While inflation was a key theme, costs were materially higher with a tight job market and rising wages impacting on margins. To make matters worse, cash flow was quite ordinary and, coming out of 15 years of low rates, this has had CFOs scrutinising their balance sheets and hopefully planning for an environment where borrowing costs continue to increase.

Our view is that companies expecting to generate cash flow in the second half (often to make up for a lacklustre first half) may be caught out in the coming months as they run down some of their “emergency” inventory in the second half of FY23 just as demand potentially dips and supply chains return to full capacity again. Companies are telling us that they can put in orders, and they are no longer having to wait two or three months to get stock. With all the challenges facing Australian companies over the past six months – and likely persist for the next six months – it is easy to forget that this is what a normal business cycle looks like. Excess inventory from excess demand gets stuck in the pipeline and must be cleared. And usually, the main way you do this is with price. We are starting to see that price element move through some of the consumer discretionary names, but not yet enough to cause problems.

This reporting season has been a reminder of why we have our four quality investment filters (Good management, Great balance sheets, Attractive industries, and Profitability) in place when identifying companies to invest in and why balance sheet is the key metric. That is the single most important factor in this part of the cycle, because as long as you've got the ability to carry the stock and not have to cut price, you should be able to take advantage of the gross margin uplift from buying that bit earlier. Another aspect to note in this part of the cycle is that when rates rise significantly, it usually takes about 18 months for earnings per share (EPS) to start the rollover fully. And while, to date, it has been lower quality stocks bearing the brunt of negative earnings revisions, an increasing number of mid-strength quality companies have generated negative EPS outlooks indicating a tougher profit cycle for some is on the horizon.

For now, the local market isn’t really pricing in a very deep or devastating recession, with the logic being that you’ve got enough buffer in a system still characterised by a lot of stored wealth. The problem is that what usually breaks these cycles is credit growth and the degree to which this is being tightened or loosened. We are now seeing the banks tightening up on credit growth, which can be seen through the increasing collateralisation requirements or spreads moving out a bit more in some of their corporate lines. Finally, when we look at the sell-side numbers, we see a lot of stale figures even after reporting season and market outlooks based more on hope than anything else. This is where we spend a lot of time and where our big team of analysts work on the proprietary research that underpins our future investment opportunities.

In terms of individual sectors, Staples weren't great but did OK relative to other sectors. Insurance did particularly well despite of the catastrophes we've had and the strengthening of reserves and reinsurance costs that have resulted. Our view is that lower insurance rates have allowed smaller players with small capital bases to compete, but they aren't going to survive in a world with real rates positive and volatility. This favours the large incumbents. In terms of the Banks, profitability as measured by net interest margin (NIM) has likely peaked and there is significant front-book competition. They banks will still be OK because of high rates, but you have to start thinking about the scenarios that may play out when very high bond volatility or spread volatility results in a credit event of some sort.

The Resources sector disappointed despite what the market may be hearing about China reopening. They've had to deal with higher costs being pushed through and labour availability issues, which in some cases is delaying new projects. Consumer Discretionary stocks generally had a good earnings season, and it is now all about how long the consumer can hang in there. The media has talked ad infinitum about the mortgage reset from variable to fixed so this is not an issue as people are already adjusting their spending to compensate. Finally, we saw an almost complete lack of guidance outlooks from the companies reporting, which is good for a big research team like ours, which is primed to do the work and find the edge we need.

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