The Economic Observer

Ausbil Dexia Limited
Australia

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Where to after an average August 2011 reporting season ?

The recent profit reporting season was overshadowed by the sovereign debt issues in Europe. However, the profit results were largely in line with expectations. The key themes we observed included a lack of company guidance, business restructuring and capital management initiatives. Even though business conditions are challenging, valuations suggest share prices reflect the majority of negativity.

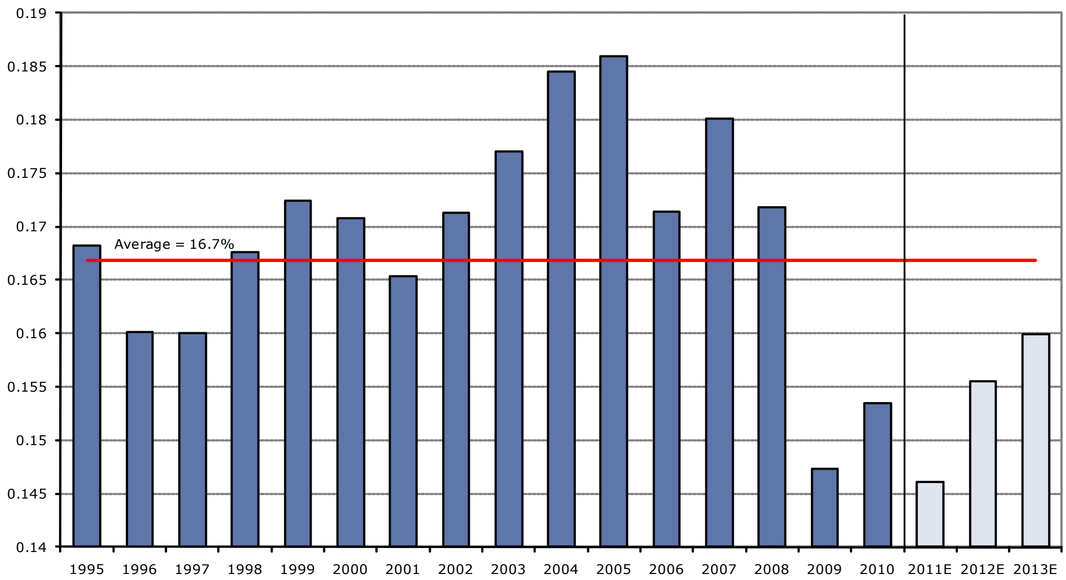
The increased global uncertainty and subsequent low levels of confidence as a result of European sovereign debt concerns did not escape Australian company boardrooms. Generally, there was a lack of company guidance on the operating outlook. This in turn has seen the market lower earnings expectations for the 2012FY and we expect additional, but not significant, downgrades to follow. The sectors to experience the largest downgrades were gold, steel, information technology, metals & mining, discretionary retail and general insurance sectors.

A number of companies across various industries announced restructuring plans or intentions to undertake strategic reviews of their businesses to address costs and inefficiencies. Inevitably this will lead to job losses which will add to weaker employment figures.

Lastly there was a notable increase in announced capital management initiatives such as share buy-backs and special dividends across a variety of industries. This indicates the financial strength of listed businesses with strong balance sheets and solid cash flows. Following from the GFC in 2008, most companies are less geared, having recapitalised their balance sheets.

However, the operating environment remains challenging for the industrials sector. The chart below illustrates that EBITDA margins have fallen to their lowest levels in 15 years. This highlights the prospect that EBITDA margins may improve for a number of cyclical industrials in future. But investors should be cautious about companies facing structural headwinds with weak business models representing potential 'value traps'.

Current ASX300 Industrials ex Financials - Historical EBITDA margins



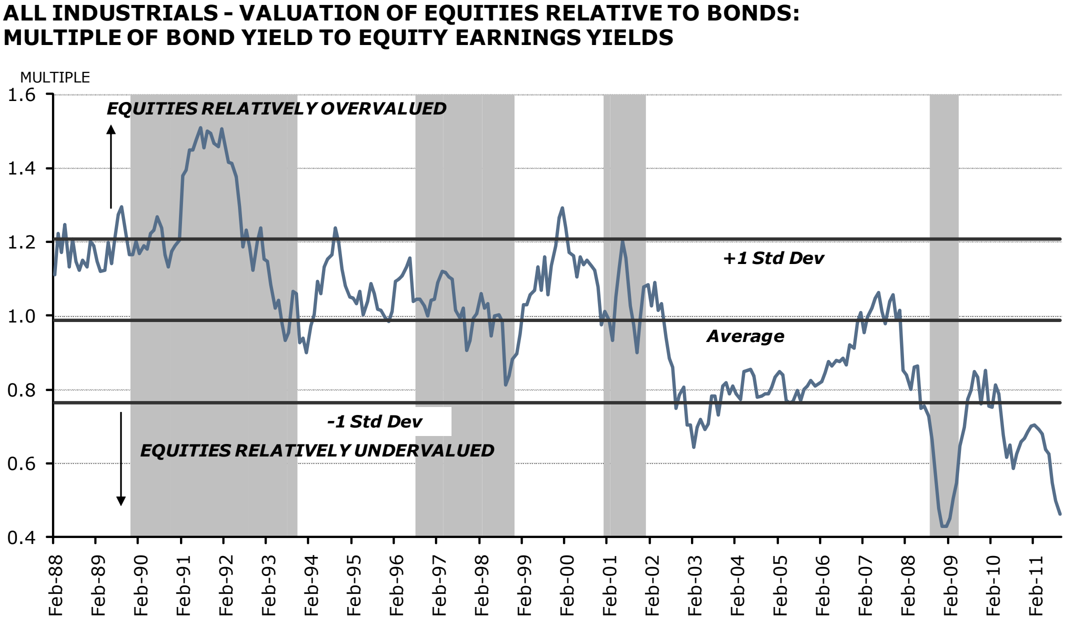
Source: Company data, GS&PA Research estimates.

From a market valuation perspective, the Australian equity market has historically (since the 1980's) traded on a forward P/E multiple of ~14.5x. Within this context, the market PE multiple of 10.4x (for the 2012 FY forecast) represents good value. The weaker global economic outlook and subsequent weakness in business and consumer sentiment justifies a discount to the historical P/E average of 14.5x, but the current discount seems excessive.

SEPT 2011	PE FY 2012 (E)	EPS GROWTH FY 2012 (E)
MARKET	10.4x	+14.7%
FINANCIALS	8.9x	+7.9%
- REITS	10.6x	+3.4%
INDUSTRIALS	12.4x	+12.0%
RESOURCES	10.1x	+28.7%

Source: Ausbil calculation based on consensus broker earnings forecasts as at 15th September 2011.

Another market valuation measure we monitor is the bond yield relative to the equity yield. The chart below highlights that this ratio is approaching 3 standard deviations below long term averages suggesting that equities are cheap versus bonds. This dispersion could indicate that investors are concerned about the sustainability of dividend yields, however, at almost 3 standard deviations below the historical average, the market has priced in an outcome which seems unlikely in our view.



Source: IRESS, GS&PA Research estimates.

There is no doubt that the Australian equity market represents good value, however, a positive catalyst to re-rate the market higher is lacking. Potential catalysts could be a reduction in the official cash rate, a weaker AUD, a change in consumer sentiment supported by the high domestic savings rate or a resolution to the European debt problem. In addition, it may be a corporate rerating via merger and acquisition activity that provides the spark.

In summary, the August profit reporting season was in line with market expectations. A key observation was that companies are well capitalised and the number of capital management initiatives surprised the market. The tough operating environment is evident, whereby company EBITDA margins are the lowest in 15 years. The Australian equity market valuations relative to bonds and historical P/E suggests the macroeconomic negativity is priced into share prices. Equity market valuations are compelling across a number of sectors, however investors will require patience to benefit as a positive catalyst is required to re-rate the market higher.