
Resources set to deliver big profits again

INVESTMENT NEWS

Investors can expect good news from reporting season, reports **James Dunn**

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WITH the June 2006 reporting season getting under way, analysts are expecting another strong earnings performance across the board, once again driven by the resources sector.

Wallowing happily in the ongoing China-driven commodities boom, Australian resources companies are expected to increase their earnings by more than 60 per cent on average, following a 79 per cent profit surge in the 2005 financial year and a 43 per cent rise the year before.

That will probably generate an average profit rise of between 16-26 per cent across the market, following 28.5 per cent in 2004-05 and 17.4 per cent the year before. There are a few signs that the party may soon be over, with the market's reliance on resources companies for profit growth exposing it to a slowdown.

Andrew Quinn, managing director of boutique investment research house Wren Research, which collates brokers' earnings forecasts, says it could hardly get better for investors than the past three financial years.

"We reckon that in the last three financial years, profit growth has averaged 19.1 per cent compound. Since 1975, the market has been able to show average earnings growth of 9.3 per cent a year. Clearly, over the last three years, the profit performance has been running well above the long-term average, driven by strong resources earnings.

"That can't go on forever, and it won't: on our numbers, the market is looking at average profit growth in the 2006-07 financial year of 7.9 per cent, which will be a seven-year low."

What concerns Quinn about the resources companies is that "there is so much room to disappoint the market". For example, he says, analysts are expecting Zinifex and Oxiana to lift profits by 300-400 per cent; and expecting BHP Billiton, Rio Tinto, Woodside Petroleum and Minara Resources to show 50-70 per cent profit growth. The problem is, he says, that there is a lot of clear space between zero and 400 per cent.

"What if Zinifex comes out with a 300 per cent profit rise - will the market be disappointed? What if Rio or Woodside or BHP can only manage 40 per cent growth? The market is really hostage to some dangerously bullish estimates for the resources stocks. Nobody knows what sort of mean reversion might happen in the commodity markets."

Hans Kunnen, head of investment research at Colonial First State, expects resources profits to hold up well. He expects to see profit upgrades by some players. "Before the commodity correction in May-June, commodity prices were going to be 50 per cent higher than last year: now they're going to be 40 per cent higher.

"I think commodity prices are going to stabilise, rather than fall, and if they do, we will see the effects of expanded volumes come in for the producers. BHP and Rio Tinto, for example, have lifted their volumes and they're planning further upgrades."

The industrial picture, however, does not look so promising, though some industrials are expected to show strong earnings growth (see table).

"A lot of people are talking up the fact that retail sales have held up well, but you must

factor in the increases in retail space that we've seen," says Kunnen. "Unless you're in a category like niche electricals, for example Harvey Norman, it's hard to see much in the way of profit growth."

The only good spots Kunnen expects to see for the industrials are those with substantial overseas earnings. "We expect the likes of CSL, Cochlear and Brambles to do well. That's on the basis of growth in the US and the global economy.

"The banks will do well, because the Australian economy is going OK, but really, it is going to be very much a resources-driven market."

Chris Pidcock, equity strategist at Goldman Sachs JBWere, says earnings momentum for the 2005-06 reporting season remains strong across the broad sectors of the market, although he sees a resources-led slowdown in 2006-07.

Pidcock does not anticipate any significant negative surprises in reported 2005-06 earnings, but notes the market has become used to upgrades exceeding downgrades, reflecting the strong earnings environment and the conservative nature of company forecasts.

Now, with margin pressures increasing - in the form of higher wages and costs - he says companies are at risk of "hitting guidance but disappointing the market".

Ernst & Young, which monitors the profit warnings given by Australian companies, says that for the second half of the financial year (the six months to June 2006), 100 profit warnings were recorded. While that number was down 35 per cent on the June 2005 half, which registered a record 155 warnings, it was a 9 per cent increase on the 92 profit warnings issued in the first half (the six months ended December 2005). Surprisingly, only 5 per cent of profit warning announcements cited increased cost pressures (including rises in oil prices).

The most common reasons were restructuring costs (15 per cent), decreased consumer spending (14 per cent) and competition pressures (12 per cent). Small-capitalisation companies again proved to have more difficult earnings to manage, says Ernst & Young. Companies with turnover of \$500 million or less were responsible for 81 per cent of the profit warnings in the June half, up from 68 per cent a year ago.