

PERSONAL FINANCE

Expect less from key market sector

Andrew Salmon, an investment strategist at **acsis**, spoke at a recent meeting of the **acsis**/Personal Finance Financial Planning Club.

By Laura du Preez

As an investor, you probably have some of your equity portfolio in the shares of listed South African industrial companies along with some resources and some financial shares.

You should know that industrial companies, such as Remgro and Pick n Pay, are in a good position to withstand the current economic downturn, but they won't be able to maintain their earnings (profits) at the high levels that investors have enjoyed over the past five years, Andrew Salmon says.

He says that despite the fact that local industrial companies have very strong balance sheets, economic headwinds will put pressure on their earnings and this will slow local equity market returns.

Salmon says you shouldn't get hoodwinked into thinking that we are currently experiencing a mild bear market, because it's actually quite a nasty one, with inflation expected to peak at 12 percent. The current inflation rate for the year to the end of April is 10.4 percent, which is way over the government's target of three to six percent.

Industrial company shares are, however, only one of three main sectors on the JSE. Resources shares and financial shares make up the other two main components.

The effect of the economic downturn on the equity market is being muted by the significant run in resources shares on the back of high commodity prices, as a result of global (and particularly developing world) demand.

The high prices of certain commodities, such as coal and platinum, are good for the local companies that produce these resources.

The performance of the resources sector is why the market is up 11 percent in the five months to the end of May this year, Salmon says.

As the resources sector is driven by factors that are outside of South Africa, it's very difficult, Salmon says, to make a call on the resources cycle and thus the fortunes of this part of the market.

The correlation between the returns of the resources shares, and shares in the industrial and financial sectors is, however, low, Salmon says.

Financial shares have fallen about 35 percent since November last year as a result of increasing interest rates and are unlikely to improve until the interest rate cycle turns, which isn't likely for the next 18 months, he says.

In the industrial sector, investors have enjoyed phenomenal earnings from South African companies. The historical growth in earnings has been about 20 percent over the past five years, Salmon says.

These good earnings are a result of industrial companies' good management, which is evident in various balance sheet and income statement ratios, Salmon says (see below: Listed industrial companies well managed).

Inflation

Despite profitable income statements and strong balance sheets, Salmon says inflation is looking ominous and is likely to breach the high it reached after the rand crisis in 2001/2. CPIX peaked at 11.3 percent in October and November of 2002.

Challenges ahead

Industrial shares therefore face a number of challenges in the next 12 to 18 months. These include:

- Slower economic growth, which should mean slower turnover;
- Rising input prices as a result of inflation;
- A softer currency, which increases the cost of imports;
- Higher interest rates; and
- Falling pricing power (the ability to increase prices without decreasing demand for the company's goods or services).

Analysts are predicting the earnings growth of industrial shares in the year ahead to be about 14 percent, but Salmon says analysts are typically overconfident and 10-percent growth is more likely.

Salmon says that one would expect industrial shares to be expensive as a result of the recent strong earnings performance, but they aren't.

The price to earnings ratio of the industrial index, which measures how expensive the shares in the index are relative to their earnings, is currently about 12.5 times, and is not high relative to its long-term average of about 13 times. The prices of these shares are, however, likely to fall amid lower earnings expectations, Salmon says.

The industrial index down is 8.13 percent for the first five months to May and you can expect this trend to continue for the rest of the year.

Most fund managers are able to move their equity exposure between the different sectors, but many prefer not to have too much of their portfolios in resources because the resources cycle is very difficult to call.

The calls your fund manager makes, however, are likely to have a significant impact on your returns.

Bumpy ride

Although long-term averages show that the equity market earns the highest returns when compared with bonds, property and cash, both locally and internationally, you should remember that investing in equities can be a bumpy ride, Salmon says. And despite excellent returns in excess of 25

percent a year from equities over the past five years, equities can deliver negative real returns (returns below inflation) in bear markets, such as the one that ended in 2003, he says.

SA'S LISTED INDUSTRIAL COMPANIES WELL MANAGED

Listed industrial companies have profitable income statements and strong balance sheets, Andrew Salmon of acsis says. This is evident from various ratios, including:

- Shareholder equity as a percentage of total assets. Since the ANC government was elected in 1994 and the economy has opened up and companies have been able to expand internationally, listed industrial companies have been reducing their shareholder equity as a percentage of their total assets, Salmon says. From average highs of about 55 percent of assets, shareholder equity is now on average about 42 percent of assets. Share buy-backs are a frequent occurrence, he says.
- Serviced debt to shareholder equity. Since 1994, companies have taken on more debt in order to become more competitive and world-class as access to global markets has opened up. It's generally better to use debt rather than shareholder capital to finance new projects, because the interest on the debt is tax-deductible and once the loan has been repaid, there are no further obligations as there would be to shareholders, who have a claim on a company's earnings.
- Working capital to sales. A company's working capital is its current assets (often the company's debtors and its stock), less its current liabilities (often the company's creditors), and is a measure of its efficiency in managing its debtors and stock to create funds to meet its short-term debts.

Salmon says listed industrial companies have reduced their average working capital-to-sales ratios from highs of 16 or more days in the early 1980s to a low of a "phenomenal" 12 days last year. He says this level is world class, and companies have made good use of information technology to manage their stock and debtors.

- Return on shareholder equity. The returns that listed industrial companies have made on the money shareholders have lent them in the past three years are at record highs, at averages of around 27 and 28 percent, Salmon says. This tells you something about how these companies are being managed, he says. These returns are almost double the current prime rate of 15.5 percent, he adds.
- Operating margins. The income a company has left over after paying its production costs (such as wages and raw materials) is its operating margin. This shows how much the company makes before interest repayments and taxes. Salmon says average operating margins have improved from a low of seven percent in 1999 to around 13 percent in the past three years.

He says this shows that companies are becoming more efficient at their respective businesses and are not just passing on price increases. These margins, in turn, have driven the return on shareholder equity, he says.

- Interest cover. This is a measure of the interest a company owes on its debt relative to its profits. The lower the ratio, the greater the chance that the company won't be able to meet its interest repayments.

Salmon says a ratio of around four is the global norm, but listed industrial companies in South Africa had an average ratio of seven last year, and the ratio was close to 10 in 2005.

- Tax rates. The average corporate tax rate of local listed industrial companies was as low as 25 percent in 1999, but is now close to 29 percent, an indication of both better tax collection and profitable income statements, Salmon says.

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