Research
Economy Watch

1 March 2024

# Earnings season highlights economic challenges

- **We parsed the earnings reports of listed companies with a macro lens to glean some insights into the economy.**
- **The balance of commentary from companies was overwhelmingly negative, consistent with economic recessionary conditions. Companies exposed to the domestic consumer, construction sector and primary sectors appeared to be the worst hit, with tourism a bright spot. Inflation pressures have eased but clearly pressures on that front remain.**
- **This comes as no surprise. Our report summarises the findings on a sectoral basis and includes key macro soundbites highlighted by each company studied.**

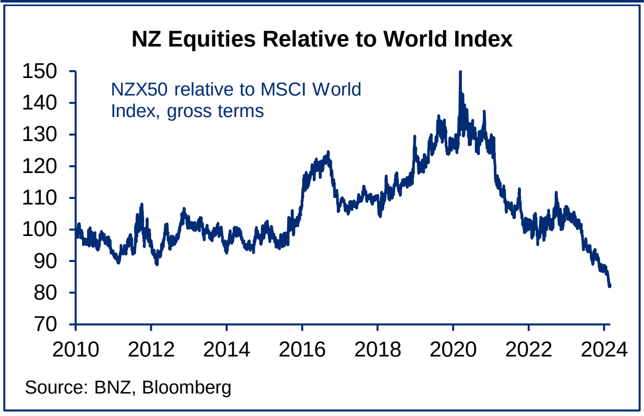
The latest corporate earnings season for NZX-listed companies has drawn to a close. The publicly available releases contain a rich source of information. We parsed the public releases and investor presentations of 39 company earnings releases through a macro lens to gather as much information as possible on the economic backdrop in NZ. This information can be timelier than official economic releases and thereby provides an added source of data to assess economic conditions.

Overwhelmingly, the vibe gathered from the commentary was ostensibly negative, with companies upfront in describing the challenging recent economic conditions. Indeed, the word “challenging” was used by 12 of the 39 companies analysed and we might have even missed a few instances of this word.

Construction, retail, and primary sectors appeared to be the worst hit. Looking at share price performance over the reporting season, three retailers made the list of the five worst performing stocks. As well as the obvious hit to demand, many companies noted the high inflation backdrop, rising cost pressures and higher interest rates eating into profitability.

Pockets of positivity were few and far between, with the recovery in tourism a rare highlight. It was pleasing to hear some comments on easing inflationary pressure on costs and looser labour markets. There were some green shoots in activity noted, although it is difficult to judge whether a genuine recovery in activity has begun or it was simply a case of the worst being over.

NZ equities underperform over recent years




The findings come as no surprise, given the backdrop of the NZ economic recession. While NZ equities have underperformed global equities over recent years, the shortfall over the past year has been particularly brutal. We put this down to a combination of the domestic macro backdrop and the sectoral make-up of the market, with little weighting to the in-favour technology sector and the over-weighting towards companies that perform worse in a higher interest rate environment.

In an Appendix we have cut-and-pasted comments taken from the releases with a focus on the macro environment, and with only some light editing.

Here’s a summary of some of the themes from a sector perspective:

**Building/Construction**: Clear signs of very weak trading conditions, with higher interest rates driving a significant downturn in the property market. Widespread de-stocking in construction materials. Short-term, companies are prepared for trading conditions to remain challenging. Some noted improving conditions in the NZ housing market and lower cost inflation.

**Media/Retail**: Most retailers are particularly under pressure, with weaker demand on low levels of consumer confidence. Rise in minimum wages noted as a factor in rising labour costs. One company, NZME, noted positive signs for 2024, with better advertising revenues, the recovering real estate market and business and consumer confidence heading in an improved direction.

**Airlines/Tourism**: Positive comments on the lift in tourism that has helped support demand, but weaker domestic conditions an offsetting factor. Air NZ noted softness in corporate and government demand since September. Significant cost inflation noted with a view to lifting domestic airfares to compensate.

**Primary sector**: Some pretty woeful conditions have been experienced in the rural sector, including horticulture. Plenty of commentary in the PGG Wrightson release that spelled out the litany of headwinds facing the sector (worth a read). Difficult harvest for 2023 in the horticulture sector due to Cyclone Gabrielle, but 2024 looking much better.

**Electricity generators**: Higher wholesale electricity prices (reflecting the cost of building new generation rising significantly) lifting revenue and costs through the sector, with price increases passed onto consumers, albeit at less than the rate of CPI inflation. Rising cost pressures from increased lines and transmission investment. Significant pipeline of investment plans, albeit reliant on Tiwai aluminium smelter remaining open, with that decision still pending.

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## APPENDIX

### BUILDING/CONSTRUCTION

#### Fletcher Building

Materially weaker trading conditions, particularly in the NZ residential sector where volumes declined 20%. House sales market was a relative bright spot in NZ, with improved buyer activity, especially first-home buyers, and a stabilising of house prices after 18 months of decline. Commercial activity slowed through HY24 and some roading work delayed. Rural market very weak on reduced agricultural spend. Ongoing destocking evident in some channels in HY24, mainly pipes and steel. Expect market volumes to remain under pressure for next 6 to 12 months, but improving conditions in NZ housing market.

#### Vulcan Steel

Following a difficult FY23, business conditions remained challenging in 1H FY24, especially in the New Zealand market. The uncertainty around New Zealand general election in October 2023 impacted on business spending and investment in 1H FY24. Higher interest rates continued to impact on business activity and investment appetite. Destocking activity among market participants has continued. High inflation added to the pressure on business costs although inflation pressure on operating costs is beginning to moderate. Trading was variable in the first six months of the current financial year, with some weakness observed in the October to December 2023 quarter. However, sales activity is showing early signs of stabilising at current levels. Customer inquiry levels have been increasing in certain segments. Our expectation is for New Zealand trading volume to begin to recover from the second or third quarter of the 2024 calendar year.

#### Steel and Tube

Subdued volumes were seen across all sectors with economic headwinds continuing the trends seen in 2H23. Volumes were down 5.1% on 2H23, with revenue down 4.4%. Economic conditions are expected to remain challenging in the short term with some easing of macro trends – interest rates, construction and cost inflation – supporting increased activity from Q4 FY24.

#### Winton Land

Result reflected the current challenging economic environment and property market. While some positive indicators are appearing, including slowing inflation, an increase in net migration, improving REINZ statistics, and decreasing residential lending rates, we remain cautious. In the short term, we are prepared for sales to remain slower, inflation to remain elevated, and continued pressure on borrowers.

#### Summerset Group

2023 had been a very good year for Summerset, despite a very challenging macroeconomic environment. Increasing inflation, recruitment shortages and a falling residential property market made business difficult throughout the year.

#### Ryman Healthcare

Profit downgrade on lower volumes on new sales of occupation right agreements. Serviced apartments in particular are taking longer to sell than anticipated at villages where the business is yet to complete its main buildings. Current mix of resales across villages and unit type is resulting in a lower average margin per unit for the second half than expected. In this environment, we continue to be very focused on our cost of doing business, and on operating efficiencies.

### MEDIA

#### Sky Network Television

+3.7% growth in revenue, driven by strong growth in Sky Sport Now, Advertising and Broadband and price increases. Many Sky Business customers are benefitting from rising tourist numbers. FY24 revenue guidance lowered due to Neon impacts and increased economic headwinds.

**NZME**

Operating revenue was 5% lower reflecting the economic conditions and a weaker real estate market. Publishing print and digital advertising revenues were most impacted by the difficult market, resulting in reduced profitability. There are positive signs for 2024, with January and February advertising revenues pacing ahead of last year, business and consumer confidence on upward trends, and a recovering real estate market.

**RETAILERS**

**KMD Brands**

A challenging start to the year, as consumer sentiment continued to weaken, with Group sales expected to be down 14.5% y/y. The wholesale channel has been more challenging (-16.8%) as wholesale accounts reduce inventory holdings.

**Hallenstein Glasson**

Sales flat in 1H24 on y/y basis, profit up 2%. The balance sheet for the Group remains strong and stock levels continue to be well controlled contributing to improved gross margin for the half.

**Restaurant Brands**

NZ same store sales up 6.2% y/y. Expects NZ sales to continue strong growth. All divisions experienced ingredient inflation and minimum wage increases, with New Zealand stores impacted the most, which impacted margins.

**Michael Hill International**

Retail segment revenue decreased by 10.3% for the half. For the first seven weeks of the second half, New Zealand segment sales are down 9.2% y/y. Gross margin was under pressure due to higher input costs for gold and diamonds, along with the Company responding to heightened competitor promotional activity across the key Christmas trading period. Inflationary pressures impacted the majority of costs across the business, most notably store labour and occupancy, the two largest cost categories.

**AIRLINES/TOURISM**

**Air New Zealand**

Passenger revenue was up 21 percent, driven by a significant ramp-up in capacity across the international network. Demand was stable in most markets, but signs of softness in domestic corporate and Government demand was experienced from September. SME segment has been resilient. Inflationary pressures also continue to be felt. Non-fuel operating costs have increased around 5 percent due to price inflation, which is on top of an increase totalling 15 to 20 percent across the last four years. The cumulative effect of these increases is having a significant impact on the cost of providing air services, including on the domestic network, and the airline is currently reviewing fares and capacity to better reflect ongoing cost pressure. A number of continuing economic and operational conditions have deteriorated and are now expected to have a significant adverse impact on performance in the second half. These include the impact of additional competition on forward revenue performance, ongoing weakness in domestic corporate and government demand, temporary cost headwinds to alleviate customer impacts and operational pressures, as well as ongoing cost inflation.

**Tourism Holdings**

Rentals performs well globally, with rental yields growing or remaining stable in all markets.  A challenging global vehicle sales environment sees fewer sales volumes. On tourism, the Chinese market is returning faster than earlier expectations, while Kiwi Experience has a good forward book, it is seeing some softness in the youth/backpacker travel market. On the outlook, rental demand and yields continue to outperform, which provides some upside potential to earnings. There also remains a level of uncertainty around retail vehicle sales, which provides downside risk.

**Skycity Entertainment**

The challenging economic climate impacted the business, particularly in domestic electronic gaming machine revenues, driven by lower consumer spend levels. Noticeable recovery of international tourism in Auckland. Hospitality and table games in Auckland performed well, with visits up 8% y/y, underpinning the hospitality businesses, including the Sky Tower, which saw visits up 37% y/y. Auckland hotel saw increase in occupancy rates from just over 77% to 87.5%. Labour constraints have eased. Sees ongoing cost inflation. Expects the challenging economic and operating environment to continue in 2H24.

**TRANSPORT**

**Freightways Group**

The NZ and AU markets have remained stable in the three months since our 1Q24 update. Activity remains broadly in line with 1Q24 trends. The half year result reflected the general state of the economies of both NZ and Australia, with volumes marginally up y/y in Express Package, with positive market share gains offset by continued lower same-customer volumes. NZ network couriers delivered a steady result, with volumes up 1.8% y/y. We expect that FY24 will reflect the tail of much higher-than-average labour cost increases, as a result of very tight labour markets in both NZ and Australia, as well as of a muted organic growth profile in most areas in which we pick up, process and deliver. Labour markets have loosened with no material vacancies in any business and a larger pool of candidates to select from. Labour costs are now moderating from the double-digit growth we had experienced in the previous year and we expect FY25 to return to normal levels of increase.

**OTHER CYCLICALS**

**EBOS Group**

The Healthcare segment delivered positive earnings growth notwithstanding the current macroeconomic environment. The Animal Care segment demonstrated strong resilience. January 2024 trading conditions were positive with earnings consistent with the levels recorded in the first half.

**PRIMARY**

**PGG Wrightson**

Materially more challenging market conditions than experienced in recent years. Factors such as elevated levels of inflation and interest rates on rising debt levels, together with subdued demand and softer returns in most of New Zealand's key primary export commodities, have all contributed to create a more demanding environment for many of PGW's farmer and grower clients. At the same time, we have seen increases in costs through supplier price rises as evidenced by ongoing CPI increases. Farm and orchard spending indicators across the board continue to point downward. Although farmer and grower confidence has improved over the period, investment intentions have fallen to their weakest since the 1980s (excluding the first COVID-19 lockdown). This is a result of high interest rates, inflation, and a decline in both meat and milk commodity prices due to softer demand in export markets and the ongoing impact of Cyclone Gabrielle for our North Island clients in both the rural and horticulture sectors. Outlook remains cautious with the agricultural sector and international marketplace facing various challenges including the impact of El Niño conditions, lower meat pricing (in particular sheep and lamb), higher input costs, softer commodity pricing for primary exports, and subdued demand from our largest export market, China. The carry over impacts of Cyclone Gabrielle together with supply chain issues associated with offshore conflicts and higher interest costs are all contributing to temper the short-term outlook and prospects. We remain cautious and expect to see subdued activity over the remainder of the financial year.

**Scales Corp**

Global Proteins delivered a solid result in a year when its petfood ingredient customers were rebalancing their inventories to lower, pre-COVID levels. This resulted in lower volumes sold. FY23 was a very challenging year for the Horticulture division, as it was for the entire Hawke's Bay horticulture industry due to the significant effects of Cyclone Gabrielle during the year. Ocean freight volumes for the Logistics division were impacted by a combination of Cyclone Gabrielle and geopolitical tensions in key trade routes. In addition, its airfreight volumes were, in part, affected by a slow start to the stone fruit season. Looking forward to 2024, we anticipate a more normal year of trading, particularly for Horticulture. Current crop indications are positive. There is also strong initial demand for our early fruit.

**Seeka**

The 2023 harvest was difficult right across the horticultural sector, as a warm wet winter, cyclones and hail significantly impacted orchards in New Zealand and Australia. Yields were down across the industry, with Seeka only handling 30 million trays of class 1 New Zealand kiwifruit in 2023, compared with 42 million in 2022. Seeka responded to the seasonal downturn by suspending dividends and reducing overheads. This included establishing a captive insurance structure to slow the impact of rising insurance costs. Having completed a number of post-harvest automation projects, Seeka also reduced its capital expenditure. The 2024 kiwifruit crop looks better, with Green volumes high and SunGold back to a normal average. Operationally, labour supply has improved.

**Skellerup Holdings**

A mixed result – Industrial Division strong, Agri Division impacted by customer destocking and timing. In the Industrial Division, growth from increased sales into water (potable and waste), hygiene and mining applications were partially offset by lower sales into leisure and roofing applications. In the Agri Division, dairy sales were softer than we anticipated as international customers reduced purchases to lower inventory. Experienced a larger than normal uplift following Christmas, and forward orders continue to be strong. Footwear sales were solid, despite drier weather in NZ. We expect some of the first half headwinds of customers reducing inventory used in dairy and leisure applications will abate.

**EXPORT FOCUSED**

**A2 Milk Co**

Grew total infant milk formula (IMF) sales despite a double-digit decline in the China IMF market (ie. market share gains). The China IMF market has contracted significantly more than expected, particularly English label channels. ANZ behind plan due to speed of innovation and challenging consumer environment. Improved revenue growth guidance for FY24 relative to prior outlook statement.

**Synlait Milk**

Reduced profit guidance on increased financing and operational costs and reduced margins.

**Comvita**

H1 FY24 results were impacted by weaker consumer sentiment in mainland China and, to a lesser degree, in North America. While China sales are still below the prior year, there are some signs of near-term improvement, with a solid uplift in Q2 vs Q1 and, pleasingly, this has continued into January. ANZ revenue improved 7%, with strong performance in the Australia domestic market.

**TECHNOLOGY**

**Vista Group International**

Total revenue up 6%, finishing the year with strong client signings to its cloud platform. Box office for 2023 up more than 30% on 2022. Guidance of revenue growth (at the mid-point) of 8%.

**UTILITIES/INFRASTRUCTURE**

**Contact Energy**

Hydro volatility characterised operating conditions throughout the period, with flow-on impacts to wholesale pricing from more thermal generation. Increasing wholesale energy and, more recently, network costs have resulted in a lift in residential electricity tariffs with the compound annual growth rate of 3% across the last five years to November 2023. Average tariff increases for the year to November 2023 of 3.7% were materially below consumer price inflation (4.7%). Total national electricity demand increased 1% from 1H23. Retail competition remains intense despite sustained high wholesale futures prices. Market churn continues to reflect this with switching at 19%. Input cost pressure for retailers is expected to remain with ongoing elevated wholesale prices and significant network cost increases pending. Retailers' pricing will need to increase to recover these rising costs.

**Mercury NZ**

Electricity futures three year forward price stable over HY24, this is partly a result of higher short term prices offsetting lower mid to long term prices.

**Meridian Energy**

Growth of 12% in retail sales revenue with financial contract, spot generation and hedging revenues all reflecting higher wholesale prices. Operating expenses up 13% in 1H24 from workforce and remuneration increases, rates uplift, higher ICT project and contractor spend, insurance premium increases. Projecting 11% rise in operating expenses over the second half.

**Genesis Energy**

Earnings were down as generation costs increased due to lower hydro inflows and the extended outage of Unit 5 at Huntly Power Station. Digital platform investments and inflationary pressures contributed to a 16% increase in operating costs. We look ahead to winter with some caution. National hydro storage is fluctuating, and gas supply is likely to be tight. Our thermal assets may again be relied upon to support the wholesale market.

**Auckland International Airport**

International aircraft movements and maximum certificated take-off weight (MCTOW) increased by 39% and 42% respectively following a strong recovery of the international airline network connecting into Auckland. The growth in international passengers and strong duty free performance drove a 52% increase in Retail income. Domestic aircraft movements and MCTOW increased by 4% and 8% respectively, with aircraft capacity constraints limiting growth in the period. Airline capacity remains below pre-pandemic levels. In the period, domestic load factors continued to be above trend and airfares remained elevated. For the remainder of FY24, we continue to see growth in capacity deployed by international airlines and strong demand for our commercial products and services. However, uncertainty remains around the pace of growth given the effect of economic headwinds on domestic demand and externalities impacting capacity to Auckland.

**Port of Tauranga**

First half of the financial year had seen a return to more normal operating conditions following a period of extreme supply chain congestion since late 2020. Service delivery to customers continues to improve with productivity rates returning to pre-Covid levels. Log export volumes increased 19.2% y/y, boosted by the ongoing early harvesting of cyclone-damaged trees in the Central North Island forests. Import container volumes decreased 17.9% y/y, reflecting lower consumer demand and increases in MetroPort rail costs. Export container volumes decreased 8%, reflecting an early end to the kiwifruit season and a slow start to the dairy export season. Direct dairy exports decreased 4.4% in volume. Direct kiwifruit export volumes were down 16.6% in volume as a result of well-publicised seasonal issues. Overall, ship visits decreased 3.9% to 674 over the six-month period. The outlook for the second half is expected to be mixed. Domestic economic conditions remain challenging, and international conflicts are causing shipping delays and increases in freight costs. Kiwifruit exports are forecast to rebound after a challenging 2023 season. Downturn in China continuing to weigh on the export log market.

**Chorus**

Continued revenue growth as fibre uptake rises. Inflation-linked cost increases drove 9.1% y/y lift in operating expenses.

**Spark NZ**

The first half of FY24 was characterised by high inflation and cost of living pressures, which flowed through to lower levels of consumer and business confidence. While Spark's products are largely resilient to economic downturns, they are not immune, and we saw weaker demand in some areas of the business. Mobile service revenue rose 6.3% as the benefit of price increases flowed through and connection growth continued. Broadband revenue remained broadly stable, despite high levels of price competition in an inflationary environment. IT revenues held flat, impacted by a slowdown in service management, primarily driven by lower public sector demand.

**Vector**

Electricity revenue is higher due to an increase in net connections, a 3.9% increase in volume, and price adjustments reflecting the impact of higher historical inflation. Gas revenue up due to increase in prices following gas reset. Higher LPG revenue due to higher prices and lower cost of LPG input prices including CP (Saudi Aramco price) is partially offset by higher cost of transportation. The international CP price of LPG has been lower compared to prior period. Auckland growth expected to continue. Connections & infrastructure activity remain elevated, necessitating significant capital expenditure.

**PROPERTY/FINANCIALS**

**Vital Healthcare Property Trust**

Adjusted funds from operations (AFFO) growth per unit below target of 2-3% per unit per annum due to debt costs rising faster than net property income and development returns, as well as relatively low levels of historic hedging. With the majority of annual rent increases linked to CPI, weighted to the second half of FY24, Vital continues to generate strong and sustainable income growth to mitigate some of the impact of higher interest rates. Interest rate hedging remains a priority with focus on extending duration.

**Precinct Properties Group**

New office leases were secured 16.4% above previous contract rents. Rent reviews completed resulted in an average annual uplift of 3.6%. Commercial Bay retail centre recorded a weaker level of sales in September and October, but trading performance was relatively strong in November and December, with sales being consistent with previous comparable periods. Higher interest rates continue to provide valuation headwinds, however investor view that rates have peaked is improving sentiment. Continued demand exists where value is obvious. Transaction volumes remain subdued. Construction costs remain elevated in nominal terms, albeit some signs of easing are emerging. Replacement costs exceed market values which will limit supply and support rental growth for existing stock, particularly for premium office where vacancy remains low. From a macroeconomic perspective, while there are short-term challenges at a local and global level, the long-term outlook across the real estate markets is underpinned by a record level of net migration which will be particularly felt in Auckland.

**Property For Industry**

Rent reviews completed on 111 leases during FY23 resulted in an average uplift of 5.0%. Auckland industrial vacancy remains near all-time lows, driving rental growth. Favourable market conditions, coupled with a portfolio that is around 16% under-rented, provides a platform for the Company to continue to grow rental income. Financial markets both here and around the globe have begun to price in interest rate cuts. With around 40% of PFI's borrowings on floating interest rates, these cuts would provide some relief to the Company's interest bill. However, changes to depreciation rules, which are likely to impact PFI from 1 July 2024, will see the Company's tax bill rise by approximately $2m a year. In addition, a range of economic indicators suggest that 2024 may be a challenging year for businesses.

**NZX**

The effects of high inflation and interest rates saw equity market trading activity remain soft resulting in a 9.7% reduction in total value traded – the lowest volume in nine years. However, economic conditions provided a tailwind for debt market activity.

**Heartland Group**

Strong growth of 18.7% in NZ Reverse Mortgages, driven by the ongoing cost-of-living strain placed on older homeowners. Growth of 6.4% in Motor Finance in a market where total new and used car sales in NZ were down 12.2%. Growth of 5.7% in Online Home Loans, well above the overall NZ market expansion in home lending of 1.7%. Strong growth of 8.9% in NZ Business against a backdrop of lower margin loans taking longer to roll off as customers take longer to refinance assets. Weak livestock price conditions and higher costs reduced confidence in the NZ Rural market and led to fewer farm sales, resulting in subdued growth.

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