The View From The Outer

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EVANS & PARTNERS

The Budget in Brief

Our Budget note is intended to provide a synopsis of the macro parameters and approach, together with brief initial observations from our analysts on the impact of specific measures for sectors and stocks they cover.

Budget Overview:

An underlying cash balance of -$41.1b or -2.6% of GDP in 2014-15, is projected to narrow to -$35.1b or -2.1% of GDP in 2015-16, and -$6.9b or -0.4% of GDP by 2018-19. The Budget balance returns to a small surplus in 2019-20. Forecast tax receipts have been downgraded by $52b over the four years to 2017-18 since the last Budget. This reflects the near halving of the iron ore price (2015-16 Budget assumption US$48/tonne) and persistently low wages growth.

The net impact of new policy decisions announced since the Mid-Year Economic and Fiscal Outlook (MYEFO) in December 2014 is a very modest +$1.6b to the Budget bottom line over the five years to 2018-19.

The improvement in the Budget position over the forward estimates, therefore, largely rests upon a recovery in nominal GDP growth in particular, and renewed stability in the Terms of Trade in 2016-17. (The Budget assumes nominal GDP growth improves from 1.5% this year, to 3.25% in 2015-16 and 5.5% in 2016-17.) The Terms of Trade are assumed to fall 12.25% this year, a further 8.5% in 2015-16, before a modest year average increase in 2016-17. Real GDP growth in 2015-16 is forecast at 2.75% before growth of 3.25% in 2016-17 and 3.5% in the following two years. These forecasts are clearly not without risk.

The pitch of the Budget stands in stark contrast to last year, when the focus on Budget repair was viewed by some as lacking an electoral mandate, measures were stalled in the Senate, and confidence suffered. The rhetoric of this Budget is more pro-growth; incentives for small business, child care reform to encourage increased workforce participation. The Treasurer concludes his Budget speech by imploring "all Australians to get out there and have a go."(1).

The two major packages, the $5.5b Jobs and Small Business Package, and the $4.4b Families Package are essentially funded by not proceeding with the Paid Parental Leave Scheme, totalling $10.1b over five years to 2018-19. Small business will receive a tax cut, while those with annual turnover of less than $2million will be able to instantly write off purchases under $20,000 until 30 June 2017. The Government message is clear; go forth and spend. We have placed little credence in the prospect of an early election/ double dissolution. If well received, and if the Senate remains recalcitrant, these measures, will be seen as keeping that option open.

Budget comments by our analysts:

Healthcare (Matt Prior) – quieter than in previous years but several changes still worth noting

The impact of the Budget on the listed healthcare universe was meaningfully less than in previous years but there were still several reforms worth noting for their indirect effect on our coverage and company specific forecasts. The 6 broad strokes of the Government's healthcare announcement with the Budget were:

i) re-iteration of the Medicare Review Task Force (announced Apr-15) which is now stated to take 2 years (previously indicated to take >6 months) and importantly defers sector reform risk for SHL & PRY beyond the May-16 Budget,

ii) reboot of the Personally Controlled Electronic Health Record, to be rebranded "MyHealth Record", at a cost of $485m (pre-announced) with indications that it will involve GP incentives and trial programs (difficult to know if SHL & PRY can benefit at this early stage),

iii) changes to Home Care and Aged Care funding where Home Care residents will now receive funding through a Gov. portal (to then spend on services) and not via the service providers directly (a net funding increase $74m) along with a program to keep residents out of entering an Aged Care facility too early after hospitalisation (saving of $56m) – with mixed effect on REG (neutral impact at this early stage),

iv) increased expenditure on the Pharmaceutical Benefits Schedule of $1.6b (with only an offsetting $252m cut) with positive inference for related companies such as SIP & API (not covered) who wholesale and distribute pharmaceuticals - and despite expectations prior to the Budget of further cuts this appears to be a net increase in spend (although the Gov. noted that they are in the final stages of negotiating the next 5 year Community Pharmacy funding agreement),

v) increased funding for immunisation rates (net funding increase of $26m) - although this appears to be more rural focused and unlikely to see meaningful benefit to SHL & PRY, and

vi) commencement of expenditure from the Medical Research Future Fund with $400m expected to be distributed (over 4 years) – though it is too early to tell if there are any listed company beneficiaries.

In addition to these 6 main areas it is important to flag a number of other smaller changes that we saw as having more direct impact on the listed operators such as: a) reduced child dental funding - a slight headwind for PRY who has a network of over 110 dentists, and b) rationalised Gov. funding for several previous initiatives such as the Gov. owned & run GP Super Clinics (who operated in direct competition with some private sector Medical Centres) which will now be halted in terms of additional roll-out of new centres – a slight tailwind for SHL & PRY who have encountered competition from existing Super Clinics – note: the total rationalisation initiative is budgeted to save $963m (over 4yrs) and is the largest single savings item (cut) in the healthcare expenditure portfolio.

Lastly, we noted that the funding for the Healthcare portfolio in aggregate remained largely unchanged (net $20m increase) excluding the impact/ reversal of the $2.9b budgeted saving (over 4yrs) that was dropped from the failed GP Co-Pay policy from the previous 2014/15 Budget (with the Medicare Review Task Force seeking alternatives to fund this forgone saving in out-years).

Retirement Incomes (Simon Fitzgerald):
As widely speculated, the Government will change the asset test threshold and the taper rate for Aged Pension from 1 Jan 2017. Importantly, there have been no changes to the deeming rules which allow annuities, of 6 years or more, a deductible amount for the asset test. This is one of the key advantages of annuities over financial investments such as an account based pension or term deposits. This is mild positive for Challenger.

Wealth Management (Simon Fitzgerald):
Unlike previous budgets there have been no changes to taxation of Australia's compulsory Superannuation system. This is a positive for the Wealth Management companies, like AMP.

McMillan Shakespeare Limited (Lou Capparelli):

The Federal Government has announced it will lower to $5,000 per employee a previously uncapped FBT exemption which allows workers in not-for-profits (charities and public hospitals) to claim meals and certain entertainment expenses. This measure may have some (minor in our view) impact on MMS's Remuneration Services business but the absence of changes to novated lease arrangements (much larger earnings driver for MMS) means the budget is of little consequence for MMS.

Asset Allocation Strategy

We make no change to our strategic asset allocation view post tonight's Commonwealth Budget. We remain neutrally positioned relative to benchmark between growth assets (equities) and defensive assets (cash / fixed interest). We retain our strong relative overweight position in international equities. Certainly most equity markets have become more expensive in absolute terms, however, the valuations of many Australian companies continue to look expensive relative to global peers.

The composition of our index and the structural challenges our economy faces require a PE discount. The S&P/ASX200 index is trading at around 16 times recent consensus forward earnings, which in turn have downgrade risk given last week's results and trading updates. We remain cautious near term as the Australian equity market rebases earnings expectations and assesses how to reprice this in a still low interest rate environment.

An overweight cash position is necessary to achieve our neutral positioning /strategic tilt between "defensive" assets and "growth" assets (that is equities) given the still very low level of long government bond yields.

The RBA reduced the Official Cash Rate to 2.0% on 5 May. While no explicit policy bias was included in the announcement, Friday's RBA Statement On Monetary Policy was quite downbeat in tone, while GDP and inflation forecasts were revised lower. The market views this as an unstated bias to ease. However, if the Fed does not lift rates until December (as we expect) and were the AUD to remain elevated in response (which we do not expect), then easing expectations will start to build again.

The RBA's view, as noted in the Governor's Monetary Policy Decision Statement on 5 May, 2015 is *"Further depreciation seems both likely and necessary, particularly given the significant declines in key commodity prices."* Indeed, the RBA Trade-weighted Index today is only 2% below end-2014 levels, despite two reductions in the Official Cash Rate. The Australian dollar has clearly been supported by the bounce in the iron ore price of over 25% since mid-April, but a bounce we expect to reverse. Supply growth is continuing, costs are falling and recently, Chinese steel and iron ore prices are diverging. PBOC easing is not a panacea to excess capacity in the property sector, where net marginal floor space started now looks very weak.

Assuming renewed Australian dollar weakness, our core forecast is for an extended period of on-hold policy from the RBA. The focus in last year's Budget on fiscal consolidation met strong resistance in the Senate and confidence suffered in response. This year's Budget is clearly aimed at supporting growth and confidence, while remaining "on a clear and credible path back to surplus." (1) Of course the outcome in the Senate given its current composition is far from clear, but this does appears a less challenging task this year.

(1) Budget speech by the Treasurer, The Hon J.B Hockey.

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