

thebigpicture

guideposts for the private investor

Week Commencing 2 December 2002

Publishing and Subscription Information

thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

To subscribe to the newsletter, go to www.thebigpicture.com.au or send an e-mail to: admin@thebigpicture.com.au.

Newsletter subscribers may also subscribe to *thebigpicture* premium content which includes tailored analysis and seminars on economics, business and policy issues affecting investment decision-making. Further information can be seen at www.thebigpicture.com.au.

◆◆◆◆◆◆◆◆◆◆

thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

GOVERNMENT CHANGES FORECASTS

The Commonwealth Treasurer has announced that short term growth prospects in Australia have been downgraded. How should individual investors react?

In its 176 page mid-year fiscal report, the government has said that:

- Australia's GDP growth in 2002/03 is likely to be lower than expected previously with its forecast dropping to 3 per cent from 3.75 per cent;
- the persistence of drought conditions has been the cause of the growth downgrade;
- the international economic and political environments mean that the downside risks to forecasts remain more obvious than any upside risks;
- the inflation risks are not significant with an expected outcome for this year and for 2003/04 within the range of 2½ per cent to 3 per cent;
- the Australian economy is in sufficiently good health that its growth rate is likely to rebound to 4 per cent in 2003/04;
- the fiscal position is only affected mildly by the growth revisions with the originally forecast fiscal surplus of \$0.2 billion being trimmed to a deficit of \$0.5 billion which is equivalent to 0.1 per cent of GDP; and,
- there is no change in the underlying cash surplus expected for the year of \$2.1 billion or 0.3 per cent of GDP which means no alteration to the expected funding task.

How important is all of this? Generally, a government's budgetary position is relevant to investors from two perspectives:

- what it implies about corporate profitability; and,
- how changes in the balance between revenues and expenditures affect funding requirements and, consequently, interest rates.

Corporate Profitability

Corporate gross operating surplus — the profit measure reported in the quarterly national accounts published by the Australian Bureau of Statistics — has grown in Australia over the past 40 years at an average annual rate just on 10 per cent. This has been against a backdrop of overall prices rising at an average 5.6 per cent per annum and output growth averaging 3.7 percent per annum. This implies that profit growth was driven by these two key macro variables with virtually no contribution from cost changes.

With prices now expected to be increasing at a rate of 2½ to 3 percent and output growth around three per cent, underlying profit growth could be expected to be 5½ to 6 per cent, substantially below the longer term average, assuming that there is no significant capacity to reduce costs.

thebigpicture newsletter for the week commencing 4 November highlighted how sensitive equity valuations are to changes in growth patterns. Using a simple growth model,

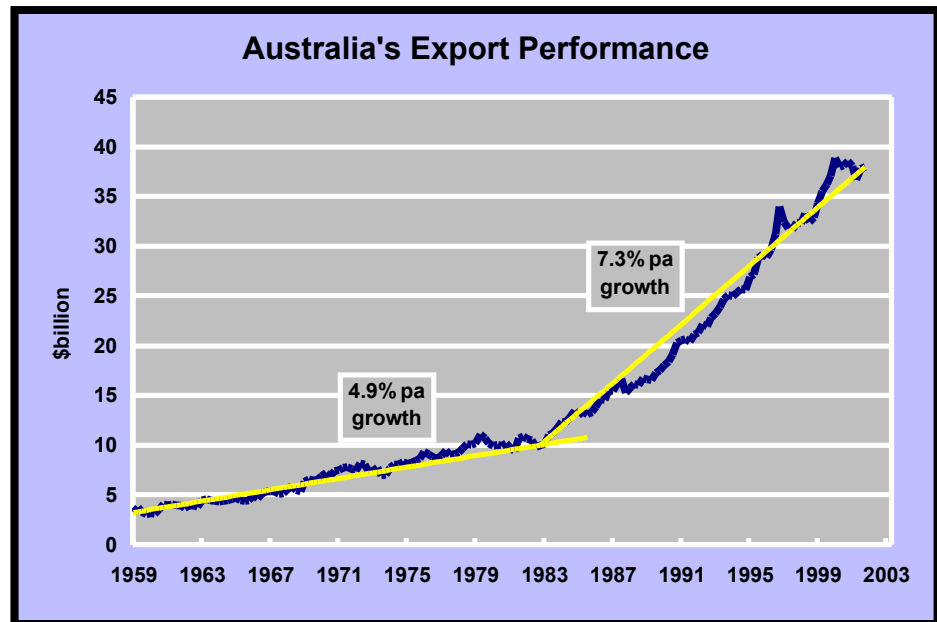
(Continued on page 2)

Impact of Growth on Value	
Expected Growth	Model p/e
3	10.3
4	11.6
5	13.1
6	15.1
7	17.8
8	21.6
9	27.3
10	36.7

THE WEEKLY CHART SPOT

"...export growth has stopped. Export volumes peaked in the September quarter of 2000.... due to the slowdown in the international economy and [t]he Australian drought...."

"With prices now expected to be increasing at a rate of 2½ to 3 percent and output growth around three per cent, underlying profit growth could be expected to be 5½ to 6 per cent, substantially below the longer term average..."



Source: Australian Bureau of Statistics quarterly national accounts constant dollar GDP expenditure components.

Australian export volumes have grown at an annualized rate of 5.9 per cent over the past four decades. However, this performance can be separated into two distinct periods. There was a clear acceleration in the rate of growth in the mid-1980s.

The change in growth trajectory coincided with several policy initiatives to restructure the Australian economy and to make Australian companies more competitive both against imports and against other companies selling in overseas markets. Australia's competitiveness was also boosted by a decline in the value of the Australian dollar against all major currencies and by as much as one third against the US dollar.

More recently, however, export growth has stopped. Export volumes peaked in the September quarter of 2000. Partly, this has been due to the slowdown in the international economy with consequently reduced demand for Australian goods. Australian drought conditions are a continuing drag on export performance because of their adverse effect on rural production.

The government, in its mid-year economic review released in the past week, has forecast that Australian exports will rise by 2 per cent in 2002/03 after having declined by 1.9 per cent in the previous year. Growth is expected to strengthen in 2003/04 in line with expectations for improved global economic conditions and an easing of the Australian drought.

GOVERNMENT CHANGES FORECASTS CONT'D

(Continued from page 1)

with a target rate of return of 13 per cent, the table shows how p/e's or share prices would vary with different long-term profit growth assumptions. A permanent reduction in growth from 7 per cent to 5 per cent, for example, would imply a 26.4 per cent reduction in underlying business value.

Of significance, therefore, in the context of the Government's announcement is its view that the medium term outlook remains largely unchanged. That is, the

longer term environment for profit growth has not changed significantly as a result of any new information which has come to light in recent months.

Interest Rates

Similarly, there is nothing of apparent significance in the Government's budgetary situation to warrant a reappraisal of the interest rate outlook. The Government's funding requirements are little changed by the review.

With inflation held in the 2½ to 3 per cent

range within Australia and with similarly tightly controlled outcomes outside Australia, the upside pressure on rates appears limited. Indeed, given the balance of forces, the interest-rate risks are more on the downside.

Why are interest rates important for investors? Interest rates affect investment returns on a number of levels. For holders of cash and debt seeking income, the answer is obvious: lower interest rates reduce nominal income. Whether real incomes also fall depends on whether there

is a commensurate reduction in inflation.

For investors in equities, however, interest rates have several influences:

- lower interest rates should lead to a reduction in the required return of investors, increasing demand for equities; and,
- lower interest rates decrease the cost of capital for companies making new investments and business acquisitions easier to justify.

THE SEARCH FOR GREENER PASTURES CONT'D

(Continued from page 4)

- the capital required to achieve their objectives; and,
- the difficulty in managing offshore product commercialization, particularly where regulatory approvals must be obtained before market access is granted.

Having underestimated the finance needed to achieve their objectives and, while still short of their commercial targets, they have had to return to the market to top up their balance sheets. This has annoyed investors. As much as anything, this may also have been the fault of corporate advisers who have not been sufficiently familiar with the needs of the company as well as investors, themselves, who were attempting to get quality on the cheap.

However, a history of disappointing returns from companies in a similar stage of development might also be relevant and Australian investors have had to suffer many early-stage listed companies whose performance has not matched the originally created expectations.

Even so, there is another perspective: if it had not been for the preparedness of the market to support such companies in the first place, they might never have been listed and given the opportunity to succeed.

Indeed, one of the longer-standing criticisms of the Australian equity market is that it has been often too ready to fund businesses without a track record, opening investors to a higher degree of risk than was desirable.

In generalizing their displeasure, the risk for Australian investors is that a few jew-

els do slip through their fingers. For companies, the risk is that they underestimate the value of being successful from Australia.

Would a company delivering against realistically established expectations still be shunned by the Australian capital market?

There might be some evidence that Australian companies which fulfill their initial promise actually develop cult-like status and achieve valuations which are sometimes embarrassingly high.

Recent examples which help to illustrate this point might be CSL, Cochlear and Billabong International. Recent falls in the share prices of each of these companies which have successfully built international businesses from Australia, emphasizes the point. Their valuations have each taken a tumble as the market realized that they were priced for perfection (or better) in a rather imperfect world. In other words, they had been given the benefit of the doubt.

So, the argument might be as follows: if, as a company, you are genuinely confident about delivering against expectations, stay in Australia and take advantage of being a hero in a small market. If you are going to fall short of your business targets, funding in Australia might well be elusive.

And that is not just a conclusion to be directed to the smallest end of the market. The larger companies which have decided to move offshore for better capital market access, BHP being one of the outstanding examples, also did so after they forced investors to reappraise their status by falling short of the performance expectations which they had largely created.

“In fact, there might be some evidence that Australian companies which fulfill their initial promise actually develop cult-like status and achieve valuations which are sometimes embarrassingly high.”

EXITING AUSTRALIA: THE SEARCH FOR GREENER PASTURES

Can Australia be a base for international corporate success? Many hitherto Australian companies are voting with their feet and, unless they have an explicitly Australian market to service, are seeking to leave because they feel that they will be appreciated better overseas. They are effectively saying that it is not possible to do international business from Australia.

Is this the reality or is it simply the lure of being somewhere different? Are Australian executives becoming too inclined to find an easy way out of business issues by relocating?

BHP, Brambles, CRA, Lend Lease, James Hardie and CSR have been conspicuous examples of the phenomenon at the big end of the market in recent times.

The problem also afflicts the smaller end of the market. A less noticed case in point is Norwood Abbey, a young company engaged in the commercialization of leading edge drug delivery systems. Its projects are all based on research conducted at high profile, credible medical research institutions in Australia and the USA.

It now has a commercial agreement in place with a partner to take its first project to market and the chairman indicated at the company's AGM in the past week that he expects it to be generating revenue at an annual rate of some \$20 million by the end of 2004. With costs apparently running at about \$6 million a year, this would imply annual NPAT approaching \$10 million.

The balance sheet, however, is like that of many early stage companies and less attractive than one would wish. Net assets of \$31.5 million at 30 June were predominantly made up of intangibles valued at \$12.7 million and deferred R&D costs of \$16.9 million. Cash on hand amounted to \$2.6 million and payables exceeded receivables by \$2.6 million. Since 30 June, the company has raised \$5.5 million and the chairman foreshadowed at the AGM that it will seek to raise another \$8 million

to cover its needs between now and the latter part of 2004 when it is scheduled to become cash flow positive.

Almost inevitably, there was some shareholder disquiet at the Norwood AGM because expectations had not been met although, as the chairman pointed out, the company's prospects, in terms of development projects, are actually stronger than he would have thought likely at the time of the company's initial public offering. It was apparent that some of the disquiet was a rub-off from shareholders' experiences with other companies which had fallen short of their targets.

As part of its ongoing development, Norwood Abbey announced that it would transfer its management to the USA progressively, list on NASDAQ and spin off a subsidiary which would be charged with developing a specific technology and which would be listed on another overseas exchange.

The company attributed the geographic relocation to its potential business partners all being located outside Australia. There was also some frustration evident about an apparent lack of support from the local capital market.

This is not an unusual scenario for companies developing new technologies. Should this be of some concern for Australian investors?

There is some truth to the claim that the local capital market is not inclined to support early stage companies.

It is probably true that venture capital funding has been less accessible in Australia although that is less the case now as more intermediaries and principals develop the expertise and appetite for this style of investment.

Whether listed companies would receive more support if they were located offshore, as is often asserted, is another matter. One consideration is that many companies, in obtaining their initial funds, have underestimated:

"...if it had not been for the preparedness of the market to support such companies in the first place, they might never have been listed and given the opportunity to succeed."

(Continued on page 3)