

# thebigpicture

guideposts for the private investor

Week Commencing 21 October 2002

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*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.

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## GROWTH AND RETURNS: HOW THE COMPANIES LINE UP

Equity market valuations have become more reasonable but the growth expectations implied by current prices are still likely to be testing.

Last week's edition of *thebigpicture* suggested that an investor should seek a target return in the vicinity of 13% from equity investments. Such a return would be sufficient to cover expected inflation, compensate for the riskiness inherent in an equity investment and generate a real return of 4%.

The newsletter also argued that an investor – as distinct from a speculator – would use the target rate of return to set a purchase price for an investment in the same way as an individual buying a whole business would value it. Put simply, an investor seeking a 10% pa return and looking to buy a business which is generating a profit of \$8,000 a year would be prepared to pay up to \$80,000.

### Equity Investment Guideposts

Required rate of return

Company return

Sustainable growth trajectory

So, on that basis, would you buy the Australian market? The short answer is "No". Existing profitability is not sufficient to deliver the required rates of return.

The tables on pages 2 and 3 show net operating profit after tax (NOPAT) for 58 of the largest companies listed on the Australian Stock Exchange. Their combined market capitalisation of \$479 billion is equivalent to about three quarters of the total capitalisation of all stocks listed on the Australian exchange.

The calculation of NOPAT was reviewed in *thebigpicture* for the week commencing 26 August 2002. As it is a pre-interest measure of profitability, it removes the distorting effects which different capital structures have on reported performance.

For example, take a company with a profit of \$100 and contributed equity of \$1000. An otherwise identical company with a different capital structure, say \$500 debt and \$500 contributed equity, might have a profit of \$72 assuming statutory tax rates and an 8% cost of debt. And yet, the underlying operating performance of one would be no different from the other. So companies need to be put on any equal footing, in terms of their capital structure, to be able to make meaningful judgements about their relative operating and financial performance.

The combined NOPAT of the 58 companies was \$36.7 billion for the last 12 month period for which they have reported. If you wanted to buy this group of companies and required a 13% rate of return, based on their existing profitability, you would value them at \$282.2 billion. However, they would also come with \$98.0 billion in debt so that you should be prepared to buy the 58 companies for \$184.2 billion. And yet, the market capitalisation of this group of companies is 2.6 times higher than this.

Over half - some 61% - of the current market value of these companies is attributable,

*"...based on the long term performance of the Australian economy and existing profitability...the targeted 13% return ....might be the upper limit of what could be expected."*

(Continued on page 2)

## Growth and Returns cont'd

\$million	NOPAT	Gross Value @13%	Net Debt	Net Value	Market Capitalisation	Profit yield (%)
Amcors	412.5	3,716	-257	3,973	6,754	6.3
AMP	1,315.8	11,854	503	11,351	14,510	8.8
ANZ Banking Group	1,751.0	15,775	n.a.	15,775	27,122	6.5
Aristocrat Leisure	93.1	839	37	802	2,121	4.3
AXA Asia Pacific Holdings	509.8	4,593	-1,001	5,594	4,390	15.0
Bank Of Western Australia	155.0	1,396	n.a.	1,396	2,283	6.8
BHP Billiton	2,108.3	18,994	7,321	11,673	36,361	4.8
Boral	236.6	2,132	881	1,251	2,392	7.2
Brambles Industries	673.8	6,070	4,308	1,762	6,672	6.1
Coal & Allied Industries	259.1	2,334	1,103	1,231	2,035	8.3
Coca-Cola Amatil	306.0	2,757	2,239	518	3,742	5.1
Cochlear	40.9	369	14	355	1,656	2.5
Coles Myer	425.8	3,836	1,294	2,543	7,723	4.7
Commonwealth Bank	2,639.0	23,775	n.a.	23,775	36,401	7.2
CSL	147.3	1,327	535	792	3,011	4.2
CSR	627.7	5,655	1,738	3,917	5,048	9.2
Flight Centre	69.6	627	-259	886	1,992	4.0
Foster's Group	688.6	6,203	3,108	3,095	9,751	5.4
General Property Trust	398.4	3,589	1,204	2,385	5,359	6.1
Goodman Fielder	177.4	1,598	534	1,064	1,830	7.5
Harvey Norman Holdings	145.0	1,307	293	1,014	2,661	4.9
Insurance Australia Group	7.2	65	1,239	-1,174	3,840	0.1
John Fairfax Holdings	79.0	712	586	126	2,044	3.0
Leighton Holdings	172.6	1,555	-524	2,079	2,570	8.4
Lend Lease Corporation	283.6	2,555	333	2,221	4,152	6.3
Lion Nathan	214.7	1,934	1,068	867	2,904	5.4
M.I.M. Holdings	216.6	1,951	1,696	255	2,277	5.5
Macquarie Bank	250.0	2,252	n.a.	2,252	4,128	6.1
Macquarie Infrastructure	583.4	5,256	872	4,384	5,168	9.7
Mayne Group	209.7	1,889	541	1,348	2,840	6.2
Mirvac Group	193.9	1,747	768	979	2,607	5.7
National Australia Bank	2,866.0	25,820	n.a.	25,820	49,346	5.8
Orica	112.7	1,015	984	31	2,721	3.0
Origin Energy	159.9	1,440	633	807	2,333	5.4
Patrick Corporation	75.7	682	-216	898	2,495	3.3
Publishing and Broadcasting	359.1	3,235	1,756	1,479	4,801	5.5
Qantas Airways	461.8	4,160	4,876	-716	6,558	4.0
QBE Insurance Group	20.5	185	3,630	-3,445	4,368	0.3

therefore, to future profit; profit over and above what is currently being generated from the existing funds employed.

Looked at another way, the current profit yield for this group of companies (measured as NOPAT relative to the value of the market capitalisation and net debt) is approximately 6.4%. To achieve a return of 13% would require a perpetual rate of growth of 6.6% pa.\*

How realistic is such a growth rate? Is that something on which an investor could legitimately take a risk? There are two guideposts to help decide.

The long term rate of growth of the Australian economy is around 3¼% pa. There is some argument, based on outcomes in the last several years, that the sustainable growth rate has increased but, against that, population growth rates are declining.

But for the GST introduction,

\*Anyone interested in the mathematics of this can see it in most business valuation texts. In essence, the mathematics says that the capitalized value of an income stream is equal to the last observed profit divided by the difference between the required rate of return and the expected growth rate. This so-called Gordon growth model is a simplification of reality and is technically correct only when the critical assumption holds: namely, the income variable is expected to have a constant average annually compounded rate of growth in perpetuity. Perpetuity is a very long time but use of the model does highlight what is required to validate existing valuations.

## Growth and Returns cont'd

*"....counting on unrealistically high prospective rates of growth to achieve rates of return is dangerous."*

Australia's inflation rate has, for the past several years, been below 3%, consistent with the rates being achieved by other western economies. While significantly lower than the inflation rates which were prevalent during most of the past 30 years, there is a substantial case to be made that sub-3% rates can become the norm, unless there is some adverse, currently unforeseen, shock to the economy.

Also, the Reserve Bank seems intent on limiting inflation to a 2-3% range. Although it has not policed the lower end of this band, it is likely to be more aggressive in preventing incursions through the upper end. Hence a 3% inflation rate seems a reasonable operating assumption.

In general terms, therefore, an Australian company could expect to be exposed to volume growth of about 3¼% pa and price increases of about 3% over the long term. Assuming, over that long term, that it is not possible to achieve anything better than overall inflation on the cost side of the profit statement, underlying profit growth of around 6¼% pa would seem a plausible

assumption.

This is lower than the 6.6% growth rate implied by the valuation of the Australian stocks but probably not significantly so. In other words, based on the long term performance of the Australian economy and existing profitability, it might be possible to reach the targeted 13% return but that might be the upper limit of what could be expected.

Obviously, these conclusions do depend on the rate of return which is being targeted. For example, if an investor was satisfied with a 10% pa rate of return, the proportion of the current market attributable to future profit growth would fall to 44% and the sustained growth rate required would be 3.6% pa, a rate which is well within historical norms and consistent with expected outcomes in the foreseeable future.

Also, Australian listed companies can have a mix of domestic and overseas exposure in their income statements and, within Australia, are likely to have disproportionate exposures to particular sectors of the economy. Their particular circumstances may expose them to growth rates and pricing conditions different to the average.

Investors need to exercise care in individual stock selection. There is a very wide range of profit yields among the 58 companies for which there are data in the table, for example. Some are better than the average and some worse.

Nonetheless, the general proposition holds: counting on unrealistically high prospective rates of growth to achieve targeted rates of return is dangerous. Stock selection should emphasize companies which have a low proportion of their current market value attributable to future growth.

As always, however, seek advice from someone you trust when it comes to taking a decision about a particular investment or product and make sure your adviser has access to research of sufficient quality to be able to value companies properly.

\$million	NOPAT	Gross Value @13%	Net Debt	Net Value	Market Capitalisation	Profit yield (%)
Rio Tinto	3,682.7	33,177	11,265	21,912	15,763	13.6
Santos	490.9	4,423	1,061	3,362	3,685	10.3
Southcorp	366.4	3,301	704	2,597	4,118	7.6
St. George Bank	376.0	3,387	n.a.	3,387	8,294	4.5
Stockland Trust Group	267.1	2,406	414	1,992	3,844	6.3
Suncorp- Metway	346.0	3,117	n.a.	3,117	5,778	6.0
Tabcorp Holdings	300.2	2,705	650	2,054	4,411	5.9
Telstra Corporation	4,199.3	37,832	12,656	25,176	30,883	9.6
Australian Gas Light Co.	312.6	2,817	2,497	320	4,422	4.5
The News Corporation	847.0	7,631	10,794	-3,163	21,022	2.7
Toll Holdings	84.7	763	329	434	1,927	3.8
Transurban Group	52.2	470	1,496	-1,026	1,964	1.5
Wesfarmers	480.1	4,325	1,317	3,008	9,936	4.3
Westfield America Trust	511.2	4,606	5,455	-849	6,675	4.2
Westfield Holdings	281.0	2,531	1,125	1,406	7,009	3.5
Westfield Trust	538.9	4,855	2,515	2,339	6,885	5.7
Westpac Banking	1,903.0	17,144	n.a.	17,144	23,539	8.1
WMC	608.3	5,481	2,108	3,373	8,566	5.7
Woodside Petroleum	981.6	8,843	1,502	7,341	8,120	10.2
Woolworths	605.1	5,452	237	5,214	13,085	4.5

## MESSAGES FROM THE AGM

**It's AGM season. Should you bother? *thebigpicture* suggests you take the time to attend because AGMs can say a lot about a company - even when it is unintentional.**

We know that any meaningful discussion with shareholders now occurs behind closed doors and that votes represented by people physically attending the AGM are only a small proportion of the total so that passage of resolutions is not dependent on those present.

But for all the stage management of the proceedings, the AGM actually says a lot about a company and its governance.

Chairmen and executives show, within the AGM, what they know about the company, its objectives and its progress. Here are some guideposts by which to judge.

**Guidepost 1:** does your chairman refer repeatedly to shareholder value? Listen to see if he knows what "shareholder value" actually means. There will be references to growth, market share, strategic positioning and new products. There is, however, only one meaningful measure of shareholder value - achieving a rate of return on funds employed in excess of the cost of capital. Still, many companies are not managed to achieve this goal. If the chairman does not refer to it in these terms, it is a sign of poor corporate governance.

**Guidepost 2:** does your chairman allow directors to speak? Many chairmen refuse to allow directors to respond to questions directed to them. Despite directors being nominally responsible to shareholders for safeguarding their investments, Boards generally adopt a united front at AGMs against shareholders. This indicates inadequate acceptance of their responsibilities and, perhaps, an indication that they are either not in agreement with the company policies or insufficiently equipped to discuss them publicly. Shareholders are entitled to know which.

**Guidepost 3:** does your chairman or CEO report performance against objectives? It is now usual for a chief executive as well as the chairman to comment on strategic is-

ues and business performance. Often these presentations are little more than an animated corporate brochure. A meaningful approach is for objectives outlined in the previous meeting to be reviewed, performance against those objectives reported and, where required, remedial action described. Revised objectives for the upcoming 12 months should be presented.

**Guidepost 4:** does your chairman report on senior executive performance? In the context of reporting on business performance, the chairman should describe what, if any, bonus or performance-related remuneration payments were made and how those payments related to corporate outcomes. Where objectives were not met, the chairman should highlight how salary payments or other rewards were affected.

**Guidepost 5:** does your chairman and CEO give a separate press conference after the AGM? It is not unusual to see newspaper stories the day after an AGM which contain information which had not been imparted at the meeting of shareholders. This is treating shareholders with contempt. On the day of the AGM, there should be no reason to have a separate meeting for press.

**Guidepost 6:** does your chairman pay lip service to the value of the company's employees? There is usually a ritual acknowledgement of the contribution of employees to the corporate performance, generally at the end of the formal corporate presentation. *thebigpicture* has argued that one measure of corporate sustainability is how management treats its employees. This is a matter being given insufficient attention. Give points to a company which highlights its employee activities first. Otherwise, see if your company provides details of even a single initiative to support the well-being of its employees through training or other development. Does it claim credit for redundancies?

Using these six guideposts, investors would gain a good appreciation of the progress of the company, its sustainability as a corporation and the standing of shareholders among directors. A company not rating well by these standards must have questions raised about its governance and its capacity to deliver adequate shareholder returns.

*"...for all the stage management of the proceedings, the AGM actually says a lot about a company and its governance."*