

thebigpicture

guideposts for the private investor

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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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VALE: AUSTRALIAN RESOURCE INVESTMENTS

The foreshadowed merger of MIM Holdings with Xstrata, a Swiss-based resources company, highlights how the Australian resource major, like the dinosaur, has failed to cope with its environment and is disappearing.

This is not good for the standing of the Australian share market. Nor is it good for investors for whom the risk of having to follow international companies with disparate geographic exposures has risen another notch. A restructuring of the Australian resource industry and how it funds its exploration activity might also be needed.

The tendency to internationalize has removed, for all practical purposes, BHP and CRA, for example, as Australian based resource companies. WMC could go the same way as it prepares itself to be sold and, now, MIM. The gold sector has gone through a similar transformation.

The risk for a resources investor has always been considerable. *thebigpicture* has referred several times in recent months to the inexorable downward pressure on commodity prices over the long term. Trying to exploit a diminishing resource when costs and prices are converging makes creating value very difficult.

The only effective way of adding value is to have an active exploration programme with a relatively high hit rate so as to have access to early stage and relatively low cost pro-

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STILL AWAITING THE E-COMMERCE REVOLUTION

The build-up in e-commerce sales in the USA remains slow.

The US Department of Commerce has estimated that the value of e-commerce sales in the USA in the third quarter of 2002 was US\$11.06 billion. That was approximately double the level of sales in the first quarter of 2000 and 34.3 percent greater than during the third quarter of 2001.

As a proportion of total retail sales, e-commerce sales have risen from 0.7 percent in the fourth quarter of 1999, the first period for which the data were compiled, to 1.3 percent in the latest period. So, even though the rate of growth in e-sales has been strong, the relative magnitude of e-sales is not statistically significant and, over the last year, the proportion of e-sales has not changed.

For investors, therefore, there appears little in the available statistics to indicate that the pattern of consumer spending is changing to favour on-line transactions at the expense of traditional forms of selling.

e-commerce sales are sales of goods or services where an order is placed by the buyer or price and terms of sale are negotiated over an internet, extranet, electronic data interchange network, electronic mail or other online system. Payment may or may not be made online.



VALE: AUSTRALIAN RESOURCE INVESTMENTS CONT'D

erties for development.

The irony here is that companies have focused very hard on reducing costs and have been continually leap-frogging one another down the cost curve. This writer wrote in the early 1990's that three quarters of the world's copper producers claimed to have their costs in the lowest quartile of the industry!

Of course, the problem for the industry in pushing costs lower was that it created conditions for prices to fall. Lower costs never provided a sustainable gain for the industry just a short term gain for the company which had made the most recent production cost reductions.

Now, companies are emphasizing their global portfolios of projects. For an investor, the challenge is to know whether the prospects of a new project in Australia might be offset by something largely unknown or unresearched in, say, Mozambique.

Will research coverage of these new international groups be adequate? There was a time when the Australian broking industry had a comparative advantage in analyzing resource companies and investors were generally well-served. Today, with fewer of the major resource companies domiciled in Australia, analysis needs to be undertaken across borders. Few research houses are equipped to do this, in part, because of the geographic spread of projects and, in part, because of the irrelevance of the resources sector in terms of its effect on overall equity market performance.

While the resources sector was such a prominent part of the Australian market, accounting for about one-third of the market capitalisation in the early 1990s, analytical resources were committed to the task. With the sector now barely the size of a single bank, the incentive to commit resources is greatly reduced.

Whether or not the resources sector was a viable way for any investor to create value in a portfolio in the longer term, the sector helped alter the risk characteristics of international portfolios when managers needed to do so. Its existence helped to create a level of interest in the Australian market which would not have otherwise been there. That point of differentiation for Australia no longer exists. Australia's listed industrial companies

generally do not stand out on the world stage sufficiently to help create a similar level of interest.

The decline in importance of the resources sector also reflects poorly on Australian management and its failure to take advantage of the economies of scale, international connections and comparative advantages bestowed upon them.

For a very brief time, MIM Holdings was Australia's second largest listed company measured by market capitalisation. MIM its peers on the Australian market had world-class skills acquired and developed in Australia and had access to international financial markets to fund new developments. It was the one business sector in Australia which was not at all dependent on the domestic market (BHP's steel interests, perhaps, excluded) and, therefore, not affected by the poor economies of scale which afflicted other Australian companies.

Directors at MIM and CSR, in the past week, as well as WMC, CRA and BHP have all opted to restructure and have their businesses driven by investment banking options rather than pursue value for shareholders through operational improvements.

Now that the majors are likely to lose their Australian identity, is there anything of interest for investors?

Australian investors will be able to invest in overseas markets but there are risks and administrative costs associated with doing so.

There might be an opportunity for the Australian industry to start afresh and rejuvenate itself in a way which could be attractive to a new generation of investors.

It is highly likely that the small scale exploration activity which is the lifeblood of a vibrant resources industry will be left to small companies and individuals with a commitment to the industry (and the lifestyle which goes with it).

In that sense, the industry will resemble more the biotech sector where companies are typically at an early stage of their development and without sufficient capital to take their innovation/find to market. In this model, initial discoveries are ultimately funded in conjunction with in-

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VALE: AUSTRALIAN RESOURCE INVESTMENTS cont'd

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ternational majors after a proof of the application/resource has been demonstrated. The majors' comparative advantages in marketing, distribution and finance are used to realize the potential of the find.

This could herald a new era for the resources sector but it will require the emergence of a new style of financial interme-

diary in Australia which has a focus on facilitating relatively small quantities of funds for early stage exploration. The pay-back will be in the sale of the property once its resources are more clearly defined. But the large scale development involving project financing which was once the hallmark of the Australian industry will not be something with which Australian companies are likely to be involved.

SUCCESSION PLANNING: A TEST OF SUSTAINABILITY cont'd

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able, for Boards, there are disadvantages in whatever course is followed. If there is no apparent successor, the company is criticized because of its lack of attention to succession planning which leads to questions about the sustainability of the business.

If there is an executive explicitly identified who is to take up the reins at some future date, the pressure begins immediately upon his appointment for him to take the lead. After all, if his credentials are so outstanding, why have him wait?

Commentators will also second guess the actions of the incumbent on behalf of the heir no matter how contented the latter might be in his role. In this sense, the Canberra press gallery style of reporting has been extended to corporate life.

Also, if there is someone explicitly appointed to take over, some of the challenge and pressure on the other executives is lost. They also become targets for other companies seeking replacement executives.

Since there is often such a wide disparity today between the chief executive's remuneration and the pay of his direct reports, the incentive to remain, if you know that the top job is not going to be yours, diminishes.

Market reactions, too, have made succession planning a little scary for Boards of directors. Even where hindsight has shown the choice of a new executive to be inspired, there has been a tendency to treat it as undesirable initially.

A good case study is Woolworths. From Paul Simon through Harry Watts, Reg Clairs and Roger Corbett it was thought hardly possible that there could be an adequate replacement at each change and the share price fell to reflect the changes.

But each new appointment demonstrated that the business dynamism which had prevailed in earlier years could continue.

But, at each change, the reaction had been adverse reflecting a preoccupation with the personality at the top rather than the fundamentals of business performance, culture and breadth of skills.

To be sure, Australia has had more than its fair share of larger-than-life personalities heading companies over the years, many of whom have left their employers in disarray. While most listed companies do not fall into this category they are tainted by the phenomenon and by businesses being treated as the embodiment of a personality.

This emphasis on the chief executive both within and outside the company has a distorting effect on decision-making and the preparedness of executives and directors to take responsibility for strategy.

There may be cases where it might be appropriate to regard the chief executive as indispensable to the business strategy. If that is the case, however, it is hardly a company in which an investment could be safe.

The preoccupation with the chief executive reflects a naïve and simplistic view of how a successful company operates by financial and business commentators, including financial analysts, who ought to know better.

Now that audit independence and other superficial matters associated with business sustainability have been dealt with, perhaps the focus of attention can be directed to far more important considerations such as how companies train people to assume executive roles and, in doing so, create a more sustainable organization for shareholders.

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SUCCESSION PLANNING: A TEST OF SUSTAINABILITY

The announcement by Foster's Group Limited that it had changed its executive responsibilities in a management reshuffle highlighted succession planning as an issue for listed companies.

The moves were commented upon so extensively, in part, because of the poor track record among Australian companies in achieving successful executive transitions so that what should be a matter of routine becomes newsworthy. In part, also, the level of interest reflected an unhealthy attitude among commentators about the role of chief executives and their dominant influence on corporate decision-making.

Nonetheless, it is true, unfortunately, that succession planning has too often been what a Board does after it has sacked a chief executive.

Investment Guideposts

1. **Cultivation of internal talent is good:** watch for signs that companies do have the requisite talent within their organizations to sustain the business.
2. **Chief executive dominance is bad:** watch for signs that the chief executive is too dominant, one key indicator being large disparities in pay between chief executives and his or her direct reports.

"...Australia has had more than its fair share of larger-than-life personalities heading companies over the years, many of whom have left their employers in disarray."

The role of the chief executive and his role in defining the nature of the organization is being reappraised. The 'hero' chief executive from overseas who has been a feature of recent Australian corporate life has had mixed success. Nor have high profile and highly paid domestic appointments been resoundingly successful. Sentiment seems to be swinging back to internal talent in the hope that people who might know the organization more intimately can bring it more lasting success if put in charge.

But even this could be fraught with dangers. There have been many examples of longstanding Australian chief executives leaving before the underlying poor performances of their businesses have become evident to investors.

Foster's happens to have a better balance than many companies within its executive ranks. It has a combination of a long-standing chief executive with a lengthy history within the company, deputies with a similarly long involvement, overseas appointments who have had extensive experience in subsidiaries held within the group and externally appointed senior level executives who are being given opportunities to show their skills.

While everyone pretty much agrees that succession planning is desir-

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Selected Company Executive Pay Relativities

Company	CEO Pay (\$m)	No. 5 Pay (\$m)	Multiple
Commonwealth Bank	7.0	1.1	6.4
Coles Myer	2.5	1.4	1.8
Orica	2.5	0.70	3.6
Goodman Fielder	1.5	1.1	1.4
Foodland	1.8	0.41	4.4
Seven Network	0.80	0.43	1.9
Burns Philp	3.9	0.56	7.0
Blackmores	0.38	0.19	2.0
Abigroup	0.80	0.39	2.1
Brambles	3.3	0.87	3.8
Mayne	3.8	0.76	5.0
Ten Network	1.2	0.53	2.3
David Jones	1.1	0.34	3.2
Wesfarmers	7.9	0.97	8.1
Telstra	2.4	1.2	2.0
Westpac	3.6	0.86	4.2

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