

thebigpicture

guideposts for the private investor

Week Commencing 26 August 2002

thebigpicture news

The flow of European economic news continued to emphasize the subdued nature of economic conditions in the region:

- euro zone inflation in July was 1.9%, below the European Central Bank's inflation target of 2.0%
- industrial production in the euro zone rose by 0.5% in June, the best performance in three months
- retail sales in the U.K grew 4.5% over the year to July, the slowest pace in 18 months.
- Germany's economy grew by 0.3% in the second quarter of 2002
- real GDP growth in the U.K. in the second quarter was 0.6% with growth over the year of 1.2%

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John A Robertson is publisher and author of *thebigpicture*. Working in Australia, London and New York, he has over 20 years experience in international financial and commodity markets, corporate strategy, financial analysis 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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INVESTOR CONFIDENCE: HOW COMPANIES AND ANALYSTS COLLUDE

Private investors, unsuspectingly, have become the losers in the relationship between companies and analysts.

This unhealthy relationship – highlighted in the Worldcom and Enron collapses – served the purposes of both companies and analysts. Analysts, thought to be dispassionate observers, actually became participants with vested interests in the outcomes they were analyzing.

Once upon a time, equity analysts began to emerge as a specialist group which was paid to review the financial reporting of companies. This would assist investors to understand often arcane and inconsistent accounting treatments and to make judgements about the financial performance of companies on a comparable basis.

Naturally, flowing from this, analysts were also asked to forecast outcomes so that investors could make some judgments about the sustainability of current performance or growth potential of individual companies. Again, done on a consistent basis, this allowed like companies to be ranked and choices to be made about preferred investments.

So far, so good. Over time, the forecasts assumed more importance and analysts began to be judged on the accuracy of their forecasts rather than strategic analysis or understanding of historic results. Their standing within their firms and their remuneration would suffer through forecast inaccuracy.

Then, equity analysis became more competitive with surveys of institutional investors ranking analysts. Soon, these rankings would become the benchmarks for determining remuneration.

These forces put growing pressure on analysts to get closer to companies - to develop relationships at various levels, initially, so as to improve their own forecasting and understanding of the businesses they were reviewing.

At the same time, markets were becoming more sensitized to the analyst forecast. Trading could be encouraged (and, thereby, broking commission generated) by betting on forecasts. Having judged what the market was expecting in the approach to a result announcement, dealers could generate trading volumes by encouraging speculators to buy or sell depending on whether they thought actual outcomes would exceed or fall short of the expected result.

This created another mini-industry: companies compiling expectations data on anything which could be forecast ranging from company earnings to monthly balance of payments outcomes or whether the RBA would move interest rates. And this has generated much of the "noise" to which private investors are subjected through the financial media on a day-to-day basis. But the market expectation was now precisely measured.

Discovering likely deviations from expected outcomes was now an important goal. This was partly an analytical task but, ultimately, only one source of information was accu-

"... companies and analysts became joined in managing market results...."

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Economic Return Analysis for Larger Listed Companies

Company Name	Return Year-1	Return Year-2	Average 2-year return
Cochlear	119.7	142.5	131.1
Aristocrat Leisure	67.7	56.5	62.1
Flight Centre	51.3	65.9	58.6
Leighton Holdings	71.9	37.7	54.8
Coal & Allied Industries	34.7	27.3	31.0
Woodside Petroleum	30.2	31.0	30.6
AXA Asia Pacific Holdings	43.9	15.0	29.4
Toll Holdings	30.0	27.8	28.9
Telstra Corporation	22.2	24.9	23.6
Macquarie Bank	26.5	19.5	23.0
Woolworths	28.3	15.4	21.8
Westpac Banking Corp.	21.7	19.1	20.4
ANZ Banking Group	20.8	19.9	20.4
Westfield Holdings	18.4	20.8	19.6
Harvey Norman Holdings	16.2	21.7	18.9
Rio Tinto	16.5	20.5	18.5
Amcor	22.0	13.6	17.8
Wesfarmers	18.2	14.5	16.4
National Australia Bank	13.4	19.0	16.2
Bank Of Western Australia	16.3	16.1	16.2
Santos	15.4	16.3	15.9
Patrick Corporation	13.0	16.9	14.9
Foster's Group	16.5	12.8	14.6
Commonwealth Bank	14.9	13.7	14.3
Suncorp- Metway	12.8	14.6	13.7
Tabcorp Holdings	14.6	11.2	12.9
Qantas Airways	10.6	13.4	12.0
Stockland Trust Group	9.1	14.4	11.8
CSL	10.6	12.4	11.5

Company Name	Return Year-1	Return Year-2	Average 2-year return
CSR	10.2	12.8	11.5
BHP Billiton	11.3	11.5	11.4
John Fairfax Holdings	9.4	12.8	11.1
Coles Myer	9.0	13.0	11.0
WMC	8.1	13.4	10.7
Southcorp	10.5	10.8	10.7
Brambles Industries	6.8	14.4	10.6
St. George Bank	12.5	8.6	10.6
Macquarie Infrastructure	12.1	7.4	9.8
Mirvac Group	9.0	9.2	9.1
QBE Insurance Group	0.9	15.5	8.2
AMP	6.0	9.8	7.9
Boral	8.3	7.4	7.9
Goodman Fielder	7.9	7.8	7.8
Transurban Group	3.9	11.7	7.8
Publishing and Broadcasting	7.6	8.0	7.8
General Property Trust	7.6	7.8	7.7
The News Corporation	1.4	13.8	7.6
Westfield Trust	7.0	8.0	7.5
Lion Nathan	7.2	6.7	7.0
Mayne Group	7.6	5.4	6.5
Orica	4.7	8.2	6.4
Australian Gas Light Co.	6.7	5.9	6.3
Lend Lease Corporation	5.7	6.5	6.1
Westfield America Trust	6.1	5.9	6.0
Origin Energy	7.3	3.2	5.2
MIM Holdings	4.0	5.2	4.6
Coca-Cola Amatil	4.3	4.5	4.4
Insurance Australia Group	0.1	3.8	2.0

The table shows rates of return on total funds employed in each of the last two financial years for which financial statements have been released. The companies included are the larger companies, measured by market capitalisation, listed on the ASX.

In calculating returns, the annual profit result is adjusted to remove the impact of debt servicing charges. The resulting measure of after tax operating performance is not dependent on the capital structure of the company. It shows the performance of companies without the distorting effect of different gearing levels on profit outcomes.

Profit results are also adjusted for non-recurring significant transactions.

The annual return calculations, using this profit measure, are based on the opening funds available to the company (measured by net debt plus total equity).

In the case of banks, which use financial assets as trading stock, the performance measure is a return on equity.

The data used to derive the summary table is from company sources released through the ASX.

RATE OF RETURN RANKINGS

The objective for any company should be to achieve a rate of return higher than its cost of capital.

A company returning more than its cost of capital is adding value. Over time, other things being equal, such companies should appreciate in value.

They should also perform better than those companies which fail to add value in this way.

A company which generated an operating profit last year of \$100 on funds employed of \$500 may grow by 20 per cent with an operating profit of \$120 in year two. Whether it did this by investing, say, another \$300 or through operational improvements which involved no additional capital employed makes a big difference to how that company should be regarded as an investment.

thebigpicture looks at stocks in four groups.

- G1: companies with a history of returning better than their cost of capital
- G2: companies which have a history of falling short of their cost of capital and for which there is no evidence of a change in performance
- G3: companies undergoing sufficient change that they could make the transition to the first group within the foreseeable future
- G4: companies which do not fit in either of the first two categories but which might have a new business offering, process innovation or intellectual property discovery. This is the speculative category.

Investors should think in terms of G1 and G3 companies making up the preponderance of an equity portfolio with a small selection of the G4 companies adding some upside potential (commensurate with their higher risk). G2 companies should be eschewed until, perhaps, there is a change in management or some other signal that it might make the transition to a G3 category.

A company's cost of capital will depend on its financial structure (i.e. how much debt verses how much equity) as well as on its riskiness (normally measured by a market volatility factor). Sometimes, a company can reduce its cost of capital by increasing

its relatively inexpensive debt and reducing its relatively expensive equity. This is the rationale of some share buy-back arrangements.

The tables opposite are indicative of the spread of returns which are currently available within the larger companies on the Australian market. The returns range from high double digit to low single digit.

Guidepost...A company with net debt equivalent to 50% of its equity, average stock price volatility and a 7½% pre-tax cost of debt would have a cost of capital of 9.2%. Its management would have to achieve a return on the funds it employs in excess of this to be adding value through its business activities. If management is not covering the cost of funding the business and has not announced plans to do so, investors should be reviewing whether to retain the holding.

The following companies highlight some of the characteristics of companies within different parts of the return rankings.

- Cochlear - the highest return company in the list and an outstanding example of a company selling a high value product based on its intellectual capital. It requires a low level of financial capital. Such an extremely high rate of return would normally justify its share price trading at a significant premium to companies with comparable levels of profitability.
- Foster's Group - a high-profile industrial company whose financial performance is now above its cost of capital indicating that it is building value. However, with little scope to improve returns through operational performance, it requires additional capital to increase profit significantly, constraining further return improvements.
- MIM Holdings - a company which has a history of poor returns more due to exploiting a depleting resource base than any particular operational or management shortcomings.
- Coca-Cola Amatil - a company towards the lower end of the rate of return of rankings which has undergone some management changes and which has foreshadowed improved returns as an important operating target.

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HOW COMPANIES AND ANALYSTS COLLUDE CONT'D

(Continued from page 1)

rate: the company compiling the earnings statement. Talk to them, build a relationship; a nod or a wink will be worth trading income and personal standing.

Within companies, meanwhile, executives were becoming ever more aware that their share prices were going to be affected by how their results related to expected outcomes. There was also evidence that companies which beat expectations consistently would attract a premium to their share prices. Companies which undershot expectations would tend to receive a discount in the market as traders were more prepared to bet against their results.

This created a another incentive for companies: to ensure that their reported results were at least in line with expectations. The expectation had evolved into something which would affect business decision-making.

Companies which thought that they were unable to meet expectations had an incentive to convey this to analysts in such a way that the share price would be less detrimentally affected than if they had simply waited until the announcement day. Thus companies and analysts became joined in managing market results.

Some of the effects can be seen in the earnings estimates of some well-known companies. For example, usually about 10-12 broking analysts follow high profile stocks like Telstra and Foster's. Currently, for the year ending June 2003, the high and the low earnings forecasts from these analysts are each within 5% of the median estimate. Yet this result is one year away, prior to the results for 2002 having been released and with these analysts coming from firms with often sharply differing views about the economic and business outlook.

Overlying this evolution and making the relationships more insidious was the use of the analyst as a means of currying favour with company executives. This was

exacerbated by declining commission rates from institutional portfolio managers and the increased reliance on fees from within the investment banking arm.

Regulatory action is being taken to separate the investment banking function from the stockbroking function but it seems unlikely that short term trading around expectations data will diminish. It is unlikely, therefore, that the murky relationship between company and analyst will be eradicated.

Private investors not privy to this relationship are at a disadvantage in trying to understand and take advantage of market movements.

Guideposts.... However, there are some guideposts which can be adopted in choosing investments to afford some protection from this phenomenon.

- Most large companies have at least twice yearly analyst briefings. Look to invest in only those companies which open briefings to all who wish to participate.
- Focus on fundamental value. Rates of return are harder to manipulate than earnings. (See page 3)
- Check to see if companies report against the expectations which were established by them at the previous briefings - if they explain why the outcomes were different, this is a good sign; a sign of honesty and transparency in reporting.

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