

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published weekly 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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‘MARKET DARLINGS’ TO ‘FALLEN ANGELS’: HOW CAN INVESTORS COPE?

Several pending corporate restructures highlight how short-lived is the success of the typical Australian listed company. This should be a genuine concern for long term equity investors because it affects adversely the overall valuation accorded the Australian market.

Today, just as immediate examples, Mayne Group, Coles Myer and WMC are each on the verge of company transforming decisions which reflect the inability of management to take advantage of prior strategic initiatives. Significantly, these are not isolated examples. They are actually closer to the norm. The Australian market landscape is littered with other similar instances.

Having to deal with the Australian corporate failure is an ongoing task for an Australian investor.

Cyclical conditions are a feature of all economies and no-one should expect companies to escape their effects. However, beyond this, Australian companies seem to suffer regularly from a form of self destruction brought on by employing strategies beyond their financial or managerial capabilities.

This ‘corporate overstretch’ could be peculiar to Australia insofar as Australian companies have to operate in a small market and are, therefore, under more pressure to develop international strategies to supplement growth. Many of the failings have been caused by international expansion. Too often, those strategies have caused companies to over reach their capabilities.

A review of the largest one hundred companies listed on the Australian exchange shows that a substantial proportion of them have suffered the ignominy of once having been regarded as a so-called ‘market darling’ and then having become a ‘fallen angel’. Some have restored themselves at least partially; others are still struggling to do so. Virtually all retain some of the scars from the experience.

thebigpicture’s review of the current top one hundred companies is summarized in the accompanying table on pages 2 and 3. From the top 100 list, property and investment companies have been excluded as have companies which are primarily foreign but which happen to be also listed in Australia (eg Alcoa Inc and Placer Dome). The remaining 69 companies have been divided into three categories.

1. **The battle scarred:** companies which have undergone a significant strategic redirection or where the market has, at some time, substantially downgraded its estimation of their capabilities.
2. **Mid-life corporates:** companies which have established a favourable reputation but have not traversed the full corporate life cycle.... as yet.
3. **The newcomers:** companies which are divestments from fallen angels or privatizations of previously government owned assets.

“Unfortunately... there is considerable pressure on Australian executives to be seen to be active. Those that are not acquiring or divesting businesses are typically identified as inadequate.”

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The Battle Scarred	
AMP	Despite having one of Australia's strongest brand identities, AMP has eroded its reputation with questionable acquisitions, apparent boardroom squabbles, executive incompatibilities, poor market communication and a failure to take advantage of a fully priced bid by National Australia Bank.
AXA	The old National Mutual also transformed a strong Australian brand identity into a company requiring a major market recapitalisation becoming effectively a foreign controlled enterprise after pursuit of market share failed.
Amcor	Once one of Australia's industrial leaders which has had to backtrack on its strategy after being unable to gain adequate returns from its assets.
Ansell/Pacific Dunlop	A high profile diversified industrial company which found it too hard to achieve adequate returns from its businesses and, having failed to communicate a coherent strategy, was talked into dismembering itself.
ANZ Banking	Another example of international 'overstretch' with investments subsequently divested and a return to a domestic orientation.
BHP Billiton	Once a proxy for the Australian market for local and international investors alike. It mistakenly persuaded itself that there could be long term returns from aging resource investments for which it paid too much. 'Strategic positioning' overtook returns as an objective. In the process, it lost the constituency looking for identifiably Australian stocks.
Billabong	Perhaps too early to be placed in this category but recent share transactions by the management and some lack of clarity in market communications have been taken as significant signs by the market that its lustre is fading.
Boral	This is another story of retreats from international investments and reorientation from energy to a sole concentration on building materials.
Brambles	A high profile diversified logistics company with a strong track record decided to become an international company through a dual listing and a focus on the most international part of its business ensuring it would be judged more harshly in a broader market context with no additional value for shareholders.
Burns Philp	A classic blue chip gone wrong. It sought global market share in commodity based products which lacked competitive positioning and lost sight of its core business. Amazingly, it survived but only with major surgery.
CC Amatil	Went for the big brand play with a commitment to Coca-Cola, eschewing its other brands and snack foods. Its Asian growth strategy appealed for a period but it was inherently a low return business with the real wealth accruing to its controllers in the USA.
CSL	It had been a 'market darling' after being privatized. There has still been a healthy return for anyone who had acquired it at the time of the IPO or thereabouts but realization that its potential growth could not match the market price has more than halved the share price.
CSR	Another of Australia's premier diversified companies of the 1980s which overstretched with its initial foray into the USA and, having been caught up in the 'resources boom' mentality of the 1980s, had to reorient itself, a process which is still underway.
Coal and Allied	This company has undergone a significant restructuring as a result of the over inflated coal valuations which had prevailed in the 1980s but was more victim than perpetrator.
Coles Myer	A classic ongoing case of corporate 'overstretch'. The gains which were to come from bringing together the parts making up this retailing giant were never forthcoming and management never appeared capable of grappling with the whole business.
Computershare	This one had a very short life-cycle. International corporate overstretch was exacerbated by poor market communications, corporate governance concerns and over dependence by the market on limited analyst research.
John Fairfax	This suffered a near death experience after an example of 1980s style financial 'overstretch' but survived thanks to the underlying cash flow strength from classified advertising.
Foster's	A Carlton and United Breweries or Elders shareholder would have been taken on one of the wildest of the 1980s rides before coming to a shuddering halt. Survival was another testimony to the advantages of a strong underlying business with cash flow.
Goodman Fielder	This company was not able to choose between being a commodity producer or a marketer of consumer brands. It has so far failed at both.
James Hardie	A conglomerate which has transformed itself into an overseas based building products company after its management could not fulfill its strategic goals.
Lend Lease	A radical strategy change converted this company from one with a domestic orientation and an outstanding record for building value to one which was internationally oriented but which had no constituency and which has failed to explain how its strategy will add value for shareholders.
Lion Nathan	This group is essentially a reconstruction of several brewing companies with very strong regional brands which had become part of the Bond Corporation saga in the 1980s but which survived, albeit greatly diminished.
Macquarie Bank	Perhaps not as dramatic as others, but this reappraisal has started as investors have questioned the sustainability of the returns and there are some questions about the governance standards within the group.

MIM Holdings	Once one of the two largest companies in Australia and a signpost for the resources sector with a global following. Consistently poor returns from an elaborate international investment strategy turned investors away.
Mayne Group	Another of Australia's premier industrial companies with a logistics focus lost confidence in its own strategy and tried to redesign itself as a healthcare provider. More recently, it thought that the 'hero CEO' might be able to paper over the shortcomings.
National Australia Bank	Survived the 1980s excesses which had damaged the other banking groups and was a 1990s success story as it used its relative strength to expand domestically and build internationally. The international strategy has been unsuccessful because of inadequate supervision and second rate assets but the share price performance has withstood the failures remarkably well.
Newcrest	A gold producer which, like so many, liked to quote its size as an indicator of success. Its investment in Normandy and subsequent management turmoil and controversial commercial judgements left it substantially diminished in the eyes of investors.
News Corporation	It had a near death experience in the late 1980s from stretching too far but recovered through a daring commitment to its strategy and the ability to organize refinancing arrangements.
Orica	Spun off by ICI, it failed to fulfill its promise after finding itself being identified as a commodity producer without pricing power. Another example of being the largest not really mattering.
Publishing and Broadcasting	This was once the Nine television network which came out of the debacle surrounding the Bond Corporation media interests. It also houses Crown Casino. Both are outstanding examples of the 'overstretch' phenomenon.
QBE	An outstanding track record for business development and financial performance which was hurt by the September 11 events and exposures most would not have expected it to have. Not a failure in the sense of others but a permanently higher risk factor might now be applied.
Rio Tinto	The old CRA had been one of Australia's highest profile companies but its management wanted to test broader horizons opting to be taken over by its parent.
Seven Network	This is another remnant of the 1980s which has been partially rehabilitated by new capital but still suffers some of the consequences of having been a part of the Skase misadventures.
Santos	Took itself overseas in the 1980s looking for growth opportunities but ended up with second rate assets which the market did not believe it could operate effectively.
Southcorp	A 1980s diversified industrial company with strong brands headed by someone who prided himself as a manager of manufacturing businesses. International expansion was too much to handle and many were seduced by the apparent glamour of the wine industry. But wine was too capital intensive for meaningful return improvement and there was pressure for transactions with the company eventually sold into a family firm which now dominates decision-making.
Telstra	A genuinely strong domestic position suffered from the over inflated expectations which had been partly created by the government as it attempted its sell-off and by the inability to identify a sustainable growth path.
Western Mining	A classic 'market darling' which went from outstanding local miner with a reputation for adding value through successful resources discoveries to buyer of worthless North American mining assets when vendors took advantage of WMCs lack of local knowledge. Its reputation and the credibility of management were forever ruined.
Westpac	An Australian company which had aspirations to be a global financial supermarket but which failed badly and became a symbol of the 1980's excess and, subsequently, a symbol of the 1990s cult of the 'hero CEO'.
Woolworths	Strong company that it appears today, this was a spin-off from a failed investment group after it became another 1980s near fatality.

The Newcomers

Australian Stock Exchange	Qantas
Bank of WA	Resmed
BHP Steel	St George Bank
Cochlear	SkyNetGlobal
Commonwealth Bank	Suncorp Metway
Lihir	TAB
Insurance Australia Group	Tabcorp
Origin Energy	Transurban
PaperlinX	

Of the largest 100 companies on the Australian exchange:

- 39 are 'battle scarred'
- 17 are newcomers
- 13 are mid-life corporates
- 16 are foreign based companies or companies being acquired by foreign companies (excluded)
- 15 are property or investment groups

Mid-life Corporates

APN News & Media
Aristocrat Leisure
BRL Hardy
Flight Centre
Foodland
Harvey Norman
Leighton
Patrick Corporation
Perpetual Trustees
Sonic Healthcare
Toll Holdings
Wesfarmers
Woodside

* As always, in making specific decisions about investments **thebigpicture** recommends that you speak with a financial adviser who has access to research of a sufficiently high quality to be able to assist in identifying what is the most suitable actions for your individual circumstances.

‘MARKET DARLINGS’ TO ‘FALLEN ANGELS’: HOW CAN INVESTORS COPE? CONT'D

(Continued from page 1)

Of course, this categorization understates the phenomenon of Australian corporate failure. There are many companies which existed in the 1980s and 1990s and which suffered so severely from ‘corporate overstretch’ that they literally ceased to exist. There are also companies which have suffered ‘overstretch’ and which have dropped out of the top 100 but which are still in business.

Companies have to take valuable time to reappraise their situation, readjust and then rebuild. No matter how successfully this is done eventually, it affects shareholder returns adversely. Moreover, the absence of a history of successful companies means that the important overseas investor treats Australia as largely a speculative market rather than one in which funds can be placed securely for the long haul.

It reflects poorly on the Australian market that such a large number of companies could have undergone such a reappraisal without having fallen from the top 100. The absence of sufficient substitutes for these strategic failures holds back the performance of the overall Australian market.

What does this mean for an investor? It certainly means that you should be very wary about success. But what can someone do who must deploy some of their wealth in equities. Obviously, it is an argument in favour of maintaining an exposure in overseas equities. This would alleviate the probability of Australian ‘overstretch’ afflicting portfolio performance. But, for most, a wholly overseas portfolio would be a big call and bring its own risks.

Is there anything which typifies Australian ‘overstretch’ and which could act as a warning for Australian investors when one of their investments is about to fall victim?

In addressing this, *thebigpicture* comes back to fundamental analysis and the need for investors to focus on companies concerned about rates of return as their

primary objective.

A common factor among companies suffering from ‘overstretch’ is that they become overly preoccupied with growth, market share, overseas exposure, strategic positioning and similar sentiments which reflect ego more than concern about financial performance. In many cases, such objectives have been pursued without regard to how much they might cost.

Unfortunately, the Australian market is a small community and there is typically considerable pressure on Australian executives to be seen to be active. Those that are not acquiring or divesting businesses are typically identified as inadequate. This is a cultural issue which needs to be overcome. Rather than the acquisition or similar strategic initiative being an unusual or rare event to supplement operational success, it is seen as a mark of achievement. Straightforward operational success is little appreciated.

Acquisitions have a role. When they happen, however, there should be conclusive evidence that they are capable of generating the necessary rates of return without there having to be too many assumptions about growth to justify the transaction.

Here is a suggested guidepost*. No matter how well performed a company might have been in the past, as soon as one sees that it is departing from a disciplined investment approach, the company should be sold from a portfolio!

What constitutes a disciplined investment approach? As *thebigpicture* has argued elsewhere, this is best measured as a return on the total funds (debt plus equity) employed in a business and compared with a cost of capital (or an individual investor’s target rate of return).

To quit seemingly successful companies might seem a severe recommendation in the short term. Based on the history of the Australian market, however, to do otherwise might just be too risky and too contrary to a compelling body of evi-

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