

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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DUAL LISTINGS: WHERE ARE THE BENEFITS?

Australian dual listed companies (DLCs) have failed to provide shareholders with many of their advertised benefits. A recently published study by economists at the Reserve Bank of Australia reviewing all the examples of dual listed companies has confirmed that they have failed to deliver on key promises.

With a dual listing, two companies decide to run their businesses as one by combining their operations and cash flows but retaining their individual legal structures and original stock exchange listings in different markets. An alternative, following a cross-border merger, would be for the acquirer to establish a secondary listing on the target's old exchange to facilitate trade in the shares issued to the target's shareholders.

The DLC structure is usually pursued because:

- a traditional merger, requiring a public bidding process, is impractical for regulatory, taxation or valuation reasons;
- two primary listings supposedly allow access to a wider range of capital providers; and,
- the resultant market valuation of the combined companies is expected to be higher than if the combination had a primary listing in one of its original markets and a secondary listing in the other.

There are some disadvantages arising from the complicated structure requiring two sets of shareholders covered by two regulatory regimes. From an investor's standpoint, too, the structure might appear overly complicated and, to that extent, more risky because of limited transparency.

Brambles, BHP-Billiton and Rio Tinto are three examples of dual listings involving Australian companies. The Reserve Bank study considers 15 dual listings on international markets in drawing its conclusions.

While the impetus for the Australian companies to amalgamate came from several directions, access to capital markets was supposed to be an important benefit for a company otherwise confined to Australia. Being listed on a major exchange such as in London or New York, and included in the benchmark indexes for those markets, would provide access to capital in greater volume or less expensively according to the argument.

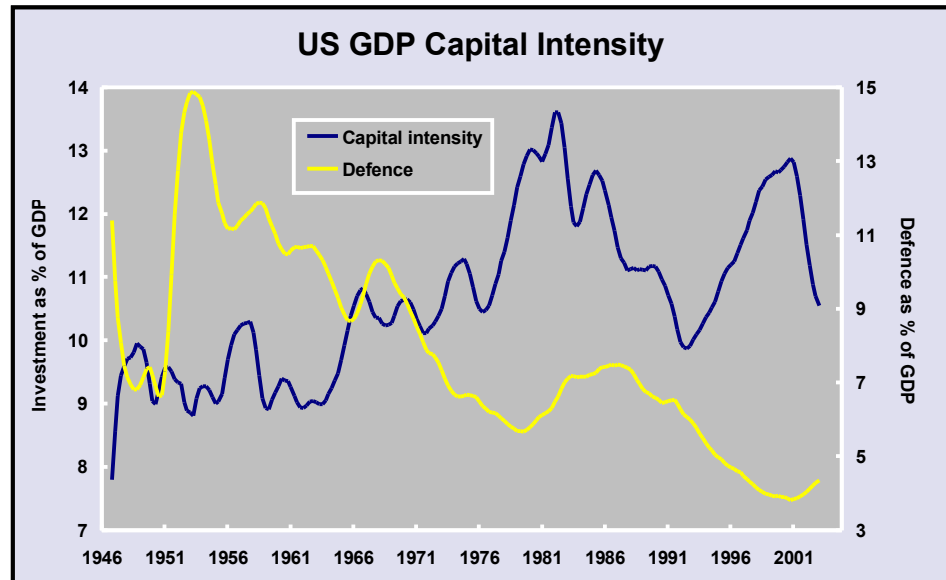
Many investors have mandates which require them to hold stocks only in designated markets. For example, a UK based investor might have to sell shares acquired when a company in which it had invested merges with a foreign listed company. Similarly, if the newly merged company was listed in the UK, those shareholders might retain their holdings but the foreign shareholders might be less willing to do so and might prefer to invest in companies with a primary listing in their local markets.

There have been many examples of large and small Australian companies listing on the New York Stock Exchange or NASDAQ through the issue of American Depositary Receipts (ADRs). Many of these initiatives occurred in the 1980s when Australian companies were persuaded that such listings would open a new window to investors. Being more visible, their shares would be priced in line with their international peers more quickly than if they remained listed only in Australia.

"... there is no empirical evidence to suggest that the DLC structure on its own creates value for investors by giving them access to larger investment markets."

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THE WEEKLY CHART SPOT



Source: US Department of Commerce

“Changes in defence spending can also crowd out private sector investment spending which has to be drawn from the same limited pool of financial resources.”

The latest US GDP statistics have confirmed the continuing slide in the capital intensity of the US economy. Non residential fixed private investment as a proportion of total GDP was 10.3% in the March quarter compared with 10.9% in the March quarter of 2002 and 13% at its most recent peak in the September quarter of 2000.

The significance of the relative weakness in capital spending is threefold implying:

- pessimism among business decision makers about their need for extra capacity and hence the economic outlook and demand for their products;
- less momentum in business productivity improvement to benefit company profits and international competitiveness; and,
- importantly for Australia, less need for commodity raw materials than would otherwise be the case.

While the importance of private investment spending has diminished, government spending on defence has begun to rise. In the March quarter, national defence spending was 9% higher than it had been a year earlier and was equivalent to 4.4% of GDP.

Higher (or lower) defence spending has frequently been associated with lower (or higher) private sector investment spending. Movements in defence spending are often associated with changed international political conditions which can also have an effect on the outlook for businesses. Changes in defence spending can also crowd out private sector investment spending which has to be drawn from the same limited pool of financial resources.

NO, TO NEGATIVE GEARING? CONT'D

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In the high interest rate case, the property investment, even with negative gearing allowed, reduced annual income after tax by over 18%. The only reason property investment would have been attractive is if the short term income losses were to be more than compensated by longer term capital gains. Rising rates were killing this prospect.

Today's circumstances compared with conditions when the last attempt was made to

abandon negative gearing are so different that the balance of political risks are also changed.

If the choices are between radical changes to health and education or tax benefits to lower income earners, on the one hand, and maintenance of negative gearing, on the other, the latter will eventually be a tempting alternative for policymakers as Mark Latham and Peter Costello each, in their own way, indicated in the past week.

DUAL LISTINGS: WHERE ARE THE BENEFITS? CONT'D

(Continued from page 1)

The reality was different. There was generally little additional liquidity from the ADR listings and international investors began to participate in the Australian market directly with considerable impact. It is not unusual for larger listed companies to have 30% or more of their shares held by fund managers based outside Australia. Overseas investors have played important roles in setting prices in the local market where Australian companies might have been undervalued relative to their peers overseas.

Australian stockbrokers have also played an important role marketing Australian companies to international investors and encouraging their involvement in the Australian market. There has been little to stop Australian companies gaining access to capital, therefore, when they have had a strong business case to back the demand.

More recently, there have been examples of companies which are commercializing biotechnologies of various sorts listing offshore because of supposed inadequate support in the local market. This, too, might be illusory.

Often, their reason for going offshore is that they have disappointed their Australian investors who refuse to contribute further to their activities. If anything, Australian investors might have been overly generous with their funding. Capital has probably been provided to companies which might have continued to be funded through private equity sources in other markets until they had reached a more advanced stage of development.

The argument, therefore, that Australian-based companies are disadvantaged by being listed in a relatively small national market is not especially compelling. One test of DLC success is whether international markets confer any pricing advantage because of the adoption of the unusual structure.

The Reserve Bank analysis (*"The Characteristics And Trading Behaviour Of Dual-Listed Companies"*, Jaideep Bedi, Anthony Richards and Paul Tennant) found persistent divergences in prices between related DLC listings. In the Australian cases, BHP and Brambles have both traded at premiums in the Australian market to the prices of their international twins. This is surprising in markets where

there are arbitrage opportunities between assets which are supposedly indistinguishable and where ADR listings are nearly always arbitrated.

The Australian dual listed companies have not been unbiased tests of the value of the structure. Brambles, BHP and CRA were all past their prime when they opted for a dual listing. All three had once been leading Australian corporations with a special place in the Australian market. By the time of the dual listing, the glow of success had been dulled. Both had lost much of their previous investment attractiveness.

Even so, the Bank study implies that international markets are not prepared to accept that a share in BHP-Billiton Limited, the Australian listed company, is the same as a share in BHP-Billiton PLC, the UK listed entity, for example.

Why should this be so given all the resources committed to persuading the markets otherwise? The Bank does not come up with a definitive answer. Their original superior standing in the Australian market, however, seems to have provided a lingering benefit to the Australian end of the DLC.

While the available examples limit how many generalizations can be made, the evidence of persistent price premiums at the Australian end "can be viewed as refuting claims that are sometimes made that companies listed on smaller markets are at an inevitable cost-of-capital disadvantage and can increase shareholder value by simply shifting their primary listing to larger overseas markets", according to the Reserve Bank. The allure of international capital markets might have come at the expense of working existing assets harder: when in doubt, opting for the smart restructuring.

The message for investors is that they must base investment judgements on whether a DLC is able to extract more income from the asset combination than would have occurred if the parts had been managed separately. Unfortunately, some of the complexities of the structure may make this a difficult assessment and that risk needs to be factored into an analysis.

In any event, there is no empirical evidence to suggest that the DLC structure on its own creates value for investors by giving them access to larger investment markets.

"The argument, therefore, that Australian-based companies are disadvantaged by being listed in a relatively small national market is not especially compelling."

NO, TO NEGATIVE GEARING?

We told you so. Negative gearing made a political appearance last week and could well return.

Coincidentally, the last edition of *thebigpicture* highlighted the possible emergence of negative gearing as a policy issue. The incentive for treading this dangerous ground would be the hard decisions on spending priorities which both sides of politics need to take and their pursuit of some additional fiscal flexibility.

In the past week, the newly appointed opposition spokesman on Treasury matters acknowledged as much (and was promptly repudiated by his leader despite the latter having only recently called for a bolder analysis of policy alternatives).

Interestingly, the Treasurer himself, when salivating publicly at the possible political fall-out, did not go so far as to throw out the possibility of change. He spoke about Mark Latham's predicament but did not explicitly make a commitment of his own to keep negative gearing. This was surprising for a politician who has a reputation for rubbing his opponents' noses in their policy messes – unless he has thought about the possibilities.

The taxation arrangements affecting housing are complicated and have arisen without a rigorous appraisal of objectives. On the one hand, there are taxation incentives operating through income tax in favour of housing and home unit development. On the other hand, at the state level, there are taxes on housing values – called stamp duties – which actually constrain activity.

Deploying several billion dollars to achieve contradictory outcomes would not be tolerated in other areas of policy. One by one the sacred cows are being eliminated. Everything from free tertiary education to the family farm has been considered dispensable in this policy making environment.

In mid 1985, after the Hawke/Keating government announced the abolition of negative gearing, the supply of rental accommodation contracted and rental costs rose dramatically.

With hindsight it is hard to justify this as an experiment from which to draw soundly based policy inferences. The circumstances at that time were extraordinary. The Reserve Bank's cash rate was in the mid-teens and set to reach 18% by December 1985. A cyclical peak in building approvals was also being reached. In other words, there would have been a dramatic fall in building activity over the time it occurred whether or not negative gearing was available.

Today, interest rates are easily 10 percentage points lower than they were then. The table illustrates an important point: an investor should prefer to have today's interest rates without negative gearing rather than the alternative.

In the example, the investor is better off by 18% a year as a consequence of lower interest rates. Without negative gearing, after tax income falls but is still 13% higher than when interest rates were 16%.

Moreover, with lower interest rates the benefit of negative gearing is greatly re-

“If the choices are between radical changes to health and education or tax benefits to lower income earners, on the one hand, and maintenance of negative gearing, on the other, the latter will eventually be a tempting alternative for policymakers....”

Negative Gearing Impact				
Home unit value (\$)	250,000			
Rental yield (%)	6			
Rent (\$ pa)	15,000			
Expenses (\$ pa)	6,000			
Gearing (%)	80			
Debt (\$)	200,000			
	High Interest Rate		Low Interest Rate	
Negative gearing?	With	Without	With	Without
Interest rate (%)	16	16	7	7
Interest (\$)	32,000	32,000	14,000	14,000
Net rental income (\$)	-23,000	-23,000	-5,000	-5,000
Personal income (\$)	100,000	100,000	100,000	100,000
Taxable income (\$)	77,000	100,000	95,000	100,000
Tax paid (\$)	24,725	35,880	33,455	35,880
Net income (\$)	52,275	41,120	61,545	59,120

duced. At the higher rates of interest it boosts income by 27% but by only 4% at the lower rate of interest.

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