

thebigpicture

guideposts for the private investor

Week Commencing 8 September 2003

Publishing and Subscription Information

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.

To subscribe to the newsletter, go to www.thebigpicture.com.au or send an e-mail to: admin@thebigpicture.com.au.

Newsletter subscribers may also subscribe to *thebigpicture* premium content which includes tailored analysis and seminars on economics, business and policy issues affecting investment decision-making. Further information can be seen at www.thebigpicture.com.au.

◆◆◆◆◆◆◆◆◆◆

thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

ANOTHER FAD: LOSE THE PROPERTY

An emerging fad among companies is to separate property assets from operating businesses. Does this make sense for shareholders? What are the guideposts which investors should apply in deciding whether restructuring in this way adds to the value of the company?

Foster's Group has been the most notable recent example of a company which has decided to raise capital by selling property assets. Its Australian Leisure and Hospitality arm, the largest operator of pubs in Australia, is going to be sold. As a part of the restructuring associated with the sale, the land on which the pubs are sited is to be placed in a separate trust and the operating business without the land is to be sold in an initial public offering.

Mayne is another company which has been reported to be considering a similar structure through which it can separate its hospitals from the land on which they sit. Qantas is also reportedly undertaking a similar review.

This goes beyond the sale of assets which are superfluous to a company's needs. In these cases, having access to the property is an intrinsic part of the overall business from the vantage point of both customers and suppliers in the case of hotels, hospitals or airports.

The land cannot simply be sold. Special agreements have to be put in place by way of long-term lease agreements to ensure that the land is accessible and the businesses can be operated without disruption.

The table illustrates the impact of the typical restructuring. XYZ Limited operates a business which generates earnings before interest and tax of \$100 million. Because it is ungeared,

Example of Operating Business with Property	
\$m	
EBIT	100
Interest paid	0
Tax paid	30
NPAT	70
P/E multiple	15
Market cap.	1,050
Value of land	700
Rental yield (%)	6
Rent payable	42
Cash deposit rate (%)	4
After restructuring	
EBIT	58
Interest received	28
Tax paid	25.8
NPAT	60.2
P/E multiple	15
Market cap.	903

it has a net profit after tax of \$70 million. As a listed company it has a market value of \$1,050 million implying a market multiple of 15 times earnings.

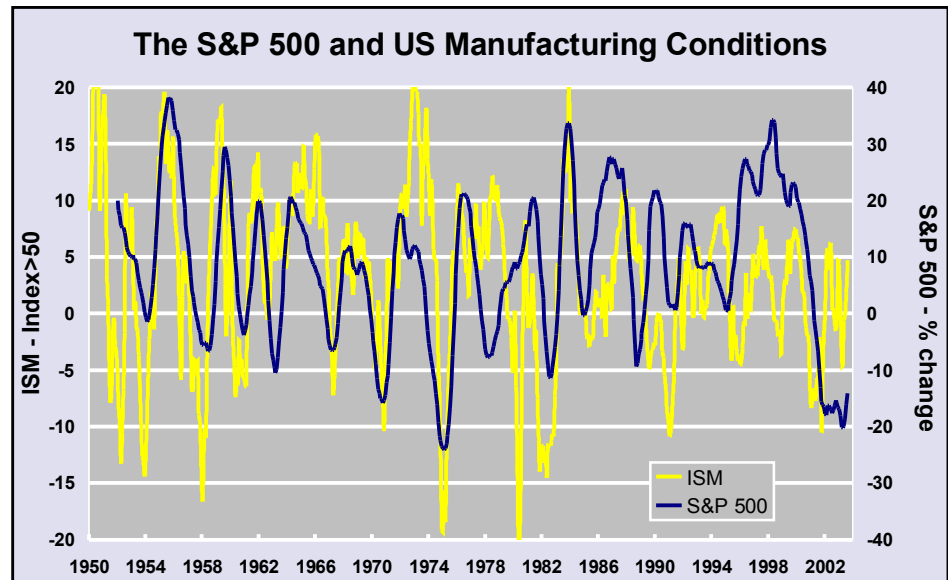
The land upon which its business operates has been valued at \$700 million. If it sells the land and enters into a long term lease agreement its profitability is reduced. In this example, the rental is equivalent to 6% of the value of the property. Assuming that the company can obtain 4% from putting the funds released on short term deposit, this would imply a net profit of \$60.2 million and, at the same market multiple, a market capitalisation of \$903 million.

If this alone were the outcome it would not be a sensible course to follow. However, the growth rate might be enhanced by the transaction. Let's say that in its original form the underlying growth in EBIT and net profit was 10% a year. Since that

"...the restructuring transactions being contemplated have little strategic value. They should be viewed simply as alternative ways of raising funds."

(Continued on page 3)

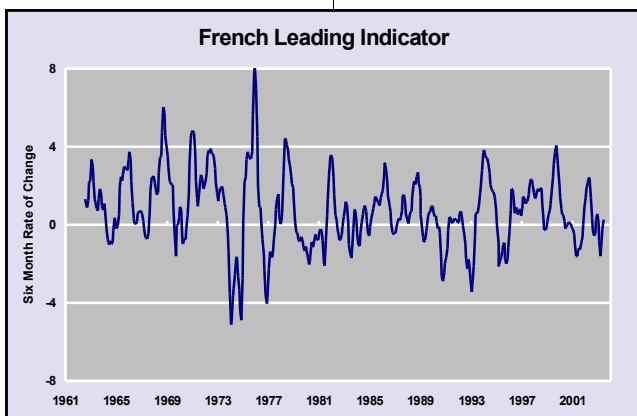
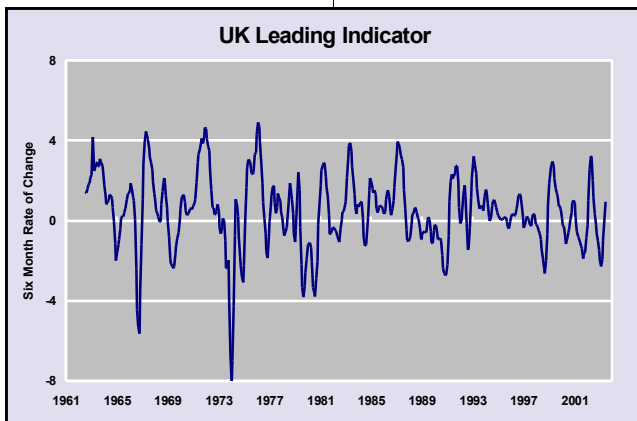
THE WEEKLY CHART SPOT



Source: Standard and Poors & Institute of Supply Managers

The Institute of Supply Managers (ISM) index of US manufacturing conditions has now put in two consecutive monthly readings above 50 (shown as a positive number on the chart) implying commencement of an expansion in manufacturing activity after signaling a contraction in activity for seven of the past twelve months.

The significant historical connection between the ISM index and the performance of the stock market also implies some basis for expecting at least more stable equity market conditions and, with further manufacturing sector expansion, some scope for values to appreciate further.



Recent European Economic signals

The following selection of economic indicators provide a short-term view of the European region.

- The Reuters purchasing managers index showed manufacturing output and new orders holding steady during August although employment contracted for the twenty-seventh consecutive month. While the overall index of manufacturing activity improved slightly, the index had registered a 17-month low as recently as June indicating continuing weakness in the manufacturing sector.
- The July service-sector purchasing managers index report showed headline service activity recovering to a seven-month high indicating stagnation rather than contracting activity.
- Germany's IFO Business Climate Index made its fourth consecutive monthly improvement. The improvement, due to perceptions of better current conditions as well as a more optimistic outlook, foreshadows a modest pickup in economic activity toward the end of 2003.
- The Center for European Economic Research (EWE) indicator of economic sentiment for Germany increased markedly in August, signaling a modest economic recovery in about six months' time.
- Inflation in the euro zone in July was 1.9%, down from 2.0% in June. Core inflation fell to 1.6%, down from 1.8%. Excess capacity and a strong euro are dampening inflationary pressures.
- Industrial production in the euro zone slipped by 0.1% in June.

ANOTHER FAD: LOSE THE PROPERTY CONT'D

(Continued from page 1)

growth depended on the operation of the business and had nothing to do with the value of the property, the original \$10 million increment in EBIT can still be expected. Now that translates into an 11.7% net profit growth rate. In theory, the p/e rating accorded the company should be higher than 15. It would have to be 17.5, however, for the value of the equity to approximate what it had been prior to the transaction.

Since many factors can affect the p/e rating accorded a company, there would be some risk that the higher rating will fail to eventuate. Shareholders would be disadvantaged as the value of the equity would be lower after the transaction than it had been before.

A second influence on the decision to proceed might be the return which can be generated on the funds which are freed. In this case, as long as the deposit rate is lower than the rental charge, shareholders are disadvantaged. If the \$700 million released from the sale of the property assets could be invested for a return higher than 6%, the net profit would be enhanced and the value of the equity improved.

Whether a shareholder is better off with one of these transactions, therefore, will

depend on whether the company has access to investment opportunities with sufficiently high returns. For there to be a benefit, the funds must be re-invested.

Consequently, a further risk which must be encountered is the new business investment risk. Most likely the risk profile of a new investment will be higher than the risk profile of the business prior to the transaction so that a suitably higher return needs to be achieved to compensate.

If the company does have investment opportunities, an alternative is to borrow the funds. Whether it chooses this course rather than selling the land assets will depend on the cost of the funds to which it has access.

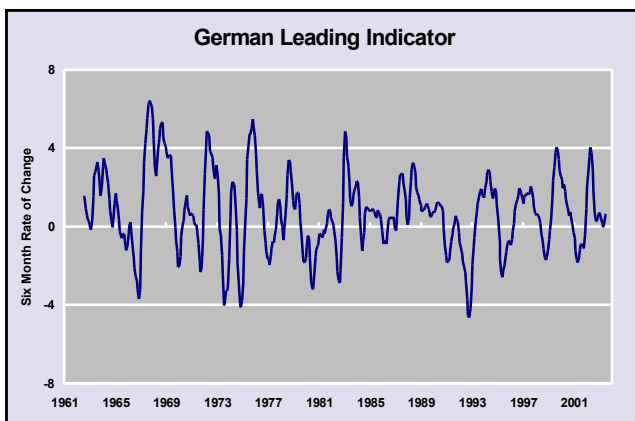
If it can borrow at less than 6%, it would make sense for it to do so as its net profit and market value should be higher by following that course rather than by selling its property assets and funding investment in that way.

In other words, the restructuring transactions being contemplated have little strategic value. They should be viewed simply as alternative ways of raising funds. Whether the transactions are worthwhile will depend simply on whether that is the cheapest source of funds or whether the company is able to invest funds sourced more cheaply from elsewhere.

“Whether a shareholder is better off with one of these transactions, therefore, will depend on whether the company has access to investment opportunities with sufficiently high returns. For there to be a benefit, the funds must be re-invested.”

Europe: Still Weak cont'd

(Continued from page 4)



European regional growth would have a meaningful effect on global conditions including a beneficial impact on the Australian outlook.

The series of charts shows movements in leading indicators for the principal European economies and for the region as a

whole. In each case, the indicator is shown in terms of its six month rate of change which, based on the OECD's analysis, provides the clearest signal of a turning point.

Looked at positively, most of the composite indicators are showing an upward trajectory implying that more buoyant conditions are ahead. However, from a more negative viewpoint, the turn has not been particularly strong implying that the conditions in the coming nine

months or so are unlikely to mean a significant difference in activity rates. Moreover, where a turn in momentum is more evident, such as in the UK, the cycle is still in its early stages and will have to mature somewhat before a meaningful acceleration in activity which might help to reduce unemployment gets underway.

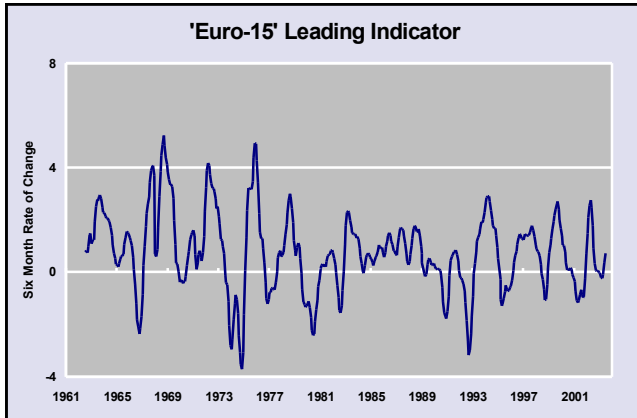
EUROPE: STILL WEAK

Growth prospects within the European region economies are continuing to disappoint.

The picture painted by the leading economic indicators compiled and published by the OECD is of a Europe showing little

sign of growth improvement in the coming year. The Euro region economies grew by a meagre 0.6% over the year to the June quarter after showing no growth in the June quarter itself.

Each composite indicator comprises a set of five to ten key short-term indicators known to foreshadow future trends in economic activity for each country.

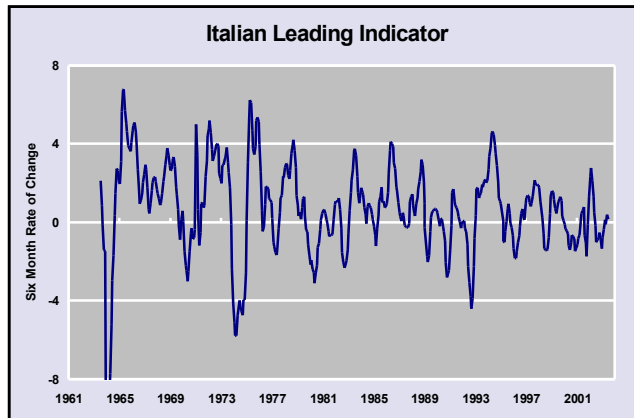


The so-called European economy approximates the size of the US economy. According to the international Monetary Fund, the 15 European economies within the European union account for some 19.7% of global GDP compared with the 23.1% attributable to the USA and Canada. Measured by population size, Europe is actually bigger accounting for 6.2% of global population compared with 5.2% in the USA and Canada.

However, despite its size, the optimism associated with political convergence in Europe and the enlargement of the economic union's membership, it has failed to match the US in terms of its flexibility to changed conditions and remains relatively closed to foreign trade, agriculture being one obvious example. The world still looks to the USA, therefore, to be the primary driver of a global growth acceleration (especially in the apparent absence of a robust recovery in Japan).

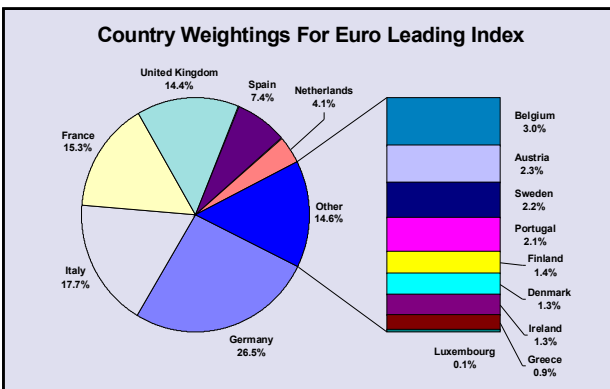
However, despite its size, the optimism associated with political convergence in Europe and the enlargement of the economic union's membership, it has failed to match the US in terms of its flexibility to changed conditions and remains relatively closed to foreign trade, agriculture being one obvious example. The world still looks to the USA, therefore, to be the primary driver of a global growth acceleration (especially in the apparent absence of a robust recovery in Japan).

The OECD compiles composite leading indicators for 23 member countries and for selected country groupings such as the 15 member Euro zone. Each leading indicator is designed to provide early signals of peaks and troughs between expansions and slowdowns of economic activity.



In practice, the indicators signal changes in the direction of the economic activity.

That said, an acceleration in



(Continued on page 3)

"...most of the composite indicators are showing an upward trajectory implying that more buoyant conditions are ahead. However, from a more negative viewpoint, the turn has not been particularly strong implying that the conditions in the coming nine months or so are unlikely to mean a significant difference in activity rates."

thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). While the information contained in this publication has been prepared with all reasonable care from sources believed to be reliable, no responsibility or liability is accepted by the publisher for any errors or omissions or misstatements however caused. Any opinions, forecasts or recommendations reflect judgements and assumptions at the date of publication and may change without notice. This publication is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment. In issuing this publication, it is not possible to take into account the investment objectives, financial situation or particular needs of any individual recipient. Investors should obtain individual financial advice to determine their investment objectives, financial situation or particular needs before acting on any information contained in this publication. This publication is not for public circulation or reproduction whether in whole or in part and is not intended for any person other than the recipient.