

# thebigpicture

guideposts for the private investor

Week Commencing 10 February 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.

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## RESTRUCTURING: ANOTHER COMPANY FALTERS

**There was yet another example in the past week of a company unable to cope with the aftermath of its own bold strategy. This time it was Southcorp. There is a bigger picture behind the demise of its chief executive.**

Aside from his suitability for the task, which seems to have been in question, the company has been afflicted by disadvantages at three levels.

- The widespread Australian corporate affliction: when in doubt, directors opting to restructure.
- The affliction facing anyone dependent on retailing to reach consumers: battling increasingly aggressive major retailers for a share of the value chain.
- The wine industry affliction: a voracious appetite for capital.

Southcorp has spent more than a decade in a state of strategic flux. It began as the major South Australian brewer. Then, it was recreated as a manufacturing conglomerate, selling water heaters, packaging and drinks, to cope with the perceived inability for a state-based brewer to survive competitively. It expanded into wine.

Then, the appeal of the wine industry got the better of executives who were persuaded that the manufacturing tag would always be too staid to excite investors. With exhortations from institutional fund managers looking for growth stories, the lengthy divestment process leading to a single purpose wine producer and marketer got underway.

Despite already having some of Australia's leading wine brands - if not the industry's premier wine brand portfolio - and a strong position in overseas markets, the financial performance of the wine division was unsatisfactory. For all the problems of the divested businesses, directors had actually decided to sell the higher returning parts of the company.

Even before the divestment process had been completed, directors were looking to repair another strategic failing. The solution was to combine two of the largest and, judged by global market penetration, most successful wine companies in the country. The combined operating skills and distribution capability would solve the problems seemingly afflicting Southcorp. To ensure this, the management of the group would be largely handed to the target's hitherto successful management team.

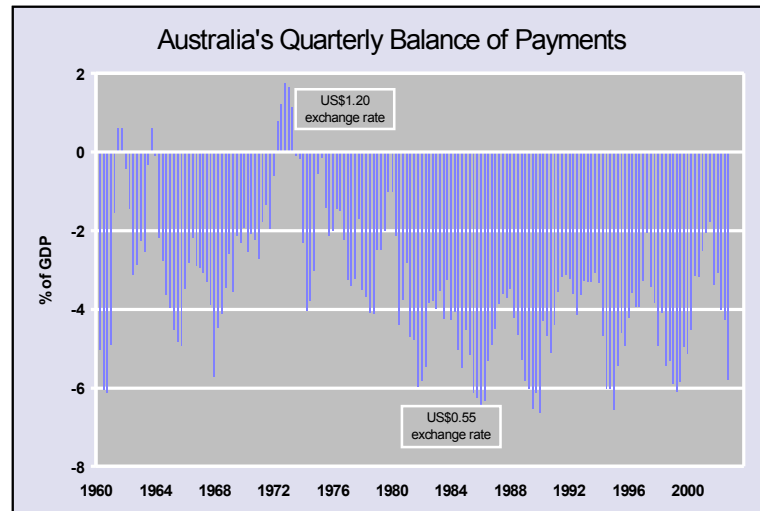
This history is worth recounting simply to illustrate that this was a company lurching from one organizational change to another. It very readily pursued the corporate re-engineering option which, with the benefit of hindsight, has yielded little for shareholders. It is now regarded as being ripe for takeover. All the intellectual capital deployed at great cost has failed to produce a sustainable business.

The battle for the value chain is another predicament from which Southcorp has been suffering. Retailers have effectively given warning that any higher margin branded goods are fair game and that they will be using their market power to extract better deals than they have achieved in the past. And, as long as they can argue that their ac-

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## THE WEEKLY CHART SPOT



*“Australia's current account deficit in the December quarter will probably approach six per cent of GDP....an outcome which is consistent with the peak deficit in prior cycles.....Worryingly, ....there has been no substantial improvement in Australia's overall international position.”*

Australia's goods and services trade deficit was a record \$3.0 billion in December implying a likely balance of payments deficit for the December quarter of around \$x billion.

Typically, the value of Australia's exports of goods and services is less than the value of the consumption and capital goods it wants to import and the net interest and dividend payments it must make. To fund the shortfall, continuing capital inflows are necessary. To the extent that those flows are not forthcoming, the exchange rate will tend lower to compensate.

The size of the trade deficit is influenced by the economic cycle.

- A weaker (stronger) international economy generally means reduced (increased) demand for Australian products and a larger (smaller) deficit.
- A stronger (weaker) domestic Australian economy generally means strengthening (reduced) imports and a larger (smaller) deficit.

For the past year and a half, the combined effects of the Australian and international economic cycles have been working to increase the deficit with weaker international activity overlaid on a relatively strong Australian economy. The effect of the drought on rural production and exports has added to the shortfall but the cyclical influences have been the predominant factor.

Australia's current account deficit in the December quarter will probably approach six per cent of GDP (illustrated with an estimate in the chart which is based on data sourced from the Australian Bureau of Statistics), an outcome which is consistent with the peak deficit in prior cycles.

Despite this consistency with historical performance, such large deficits have often, with ample justification, been associated with crisis conditions. Worryingly, for all the policy initiatives and much lauded improved export competitiveness, there has been no substantial improvement in Australia's overall international position.

The government will far too readily advise that the deficit reflects Australia's relatively good economic performance. This is being far too sanguine about the prospects, as history shows. Between the end of December 1972, when Australia uncharacteristically had a quarterly surplus equivalent to 1.7 per cent of GDP, and the middle of 1986, when Australia had seemingly locked itself into recurring deficits of up to six per cent of GDP, the exchange rate declined by 54% from US\$1.20 to US\$0.55.

For investors, in particular, there are two adverse effects arising from any further potential currency weakness:

- an erosion of critically important confidence among offshore investors with a deleterious effect on market values; and,
- greater difficulties for Australian companies competing for international assets by which to enhance their growth prospects.

## RESTRUCTURING: ANOTHER COMPANY FALTERS CONT'D

tions are benefiting consumers, there will be little regulatory constraint on the use of whatever leverage they have.

Generally, producers of alcoholic beverages had protected themselves from the increasing strength of the retailers by their branding strategies. Consumers might buy the house brand milk but were unlikely to buy Woolworths Lager or Coles Estate Chardonnay in preference to VB or Lindemans Bin 65 given the resources ploughed into persuading them that the latter two would be superior.

As well as reflecting the money being poured into brands, relative security for the alcoholic beverage marketers came from market restrictions such as limitations on where their products could be sold. Those barriers have been breaking down and, as they are, the balance of power is tilting in favour of the major retailers. The fight is not yet over by any means but there are some dangers ahead for the investor.

The balance of power will favour the retailers. While there will generally be agreement that shareholders are always the victims of discounting, only one company needs to break ranks for an industry's margins to be destroyed. The urge to grow in the Australian market will be the carrot held out by the retailers for their suppliers.

The battle between the brand manager, on the one hand, and the volume manager, on the other, has been going on for a long time and is likely to continue indefinitely. Depending on how aggressive the retailers are prepared to be, brands might

not be as valuable as they once were.

In the case of Southcorp, the synergistic benefits which arose from the combination of the two wine companies have been dissipated by the demands of the retailers.

The third pressure being faced by Southcorp, in common with the wine industry, is the capital intensity of wine production and sales. The appeal of the industry had been its outstanding growth prospects. And yet, two dollars of capital could easily be tied up producing one dollar of current year sales. This could be modified, at the margin, through more aggressive inventory control and earlier vintage releases. However, any benefits could easily be offset as more and more capital had to be committed to fund inventories for future year sales.

Ultimately, share price performance and the claim on capital for development depend on achieving competitive rates of return. Now, past the initial euphoria and novelty of a lifestyle industry, this reality is dawning and represents another pressure with which the majors need to deal.

Outcomes at Foster's, another one of the global wine majors, also highlighted this. Arguably, it has been more attuned than most to the need for improved returns from its wine investments. And yet, it indicated last year, after announcing its results for 2001/02, that its wine division had broken even on a cash basis for only the first time since it embarked upon its wine strategy. This was so despite the wine division having reported an EBITA of \$486.6 million.

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## HAVE YOU HEARD? NO MORE RUMOURS CONT'D

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on rumours, even where discussions might not have commenced, places and an upward bias on share prices which might disadvantage bidders.

- Public acknowledgement of a potential purchase might also attract other bidders interested in the assets or others who might simply be attempting opportunistically to gain a financial advantage.
- Companies seeking to sell assets could be disadvantaged if potential sales, having been acknowledged, fail to materialize. A company could be

worse off having failed to conclude than if no initiative had been taken.

The upshot is that companies will probably have to be more forthcoming and risk, in having to provide more information, imposing additional costs on their shareholders.

A conspicuous example of a failed transaction attributable to premature forced publicity may precipitate a change in requirements. Generally, however, the costs will be so difficult to quantify that reversion to the old arrangements will be unlikely no matter how intensely the changes aggravate some executives.

## HAVE YOU HEARD? NO MORE RUMOURS

**The continuous disclosure regime under which Australian listed companies must operate has been toughened since 1 January. Now companies must respond, under certain circumstances, to market rumours about their activities. This helps private shareholders but also opens up new avenues for abuse.**

Australian listed companies operate under a continuous disclosure regime which requires them to inform the market whenever executives become aware of any event which could have a material impact on the share price of their company.

Until the change, companies had been allowed some latitude. In cases where they were negotiating price sensitive transactions, for example, they were not required to inform the market as long as the transactions were confidential and no definitive agreement had been reached.

In practice, it is very difficult to keep a major transaction under wraps until an agreement is signed.

- As the circle of advisers is widened, the risk that someone talks deliberately or inadvertently is increased.
- Analysts are continually poring over listed companies to anticipate their next strategic steps. Some changes are so logical that they are openly and widely canvassed to the point that the market comes to expect them and speaks of them as reality.
- The possibility of a transaction could be publicized for malicious reasons.
- Information can be communicated accidentally by executives being seen arriving in a city or meetings being observed or conversations overheard.

If a potential transaction became known for any of these reasons, it had become commonplace to respond by saying that the company did not comment on speculation as a matter of principle. Sometimes, when a strong rumour was untrue, a company might announce that there was no substance to it (although pointing

out that such a comment should not be taken as a precedent for other occasions when rumours might circulate).

The problem here was that the practice would vary among companies and, within the same company, over time. The disadvantage for investors was that the inconsistency made it difficult to assess how to react although experience provided some lessons. The executive who said, when quizzed, that there was no "current intention" meant just that: the statement was often valid only for that instant.

Private investors were doubly disadvantaged. Institutional and larger professional investors could approach a company and sometimes elicit an informal response to a rumour which was not being conveyed more widely.

Now, everyone must be told at the same time whether "a reasonably specific rumour or media comment" is correct or not. This offers investors an additional degree of protection. There should be less ambiguity attaching to company statements; they should be less open to interpretation.

The first judgement which needs to be made is what constitutes a rumour to which a formal response must be given. How specific does it have to be? If some of the details are wrong, can it be ignored? Must a rumour be reported by the mainstream press before a response is required? Anywhere judgements are required, there is a risk of inconsistency which is where the regulatory problems arise.

However, everyone now knows that circulating a rumour will put a company on the spot. It can be forced to respond no matter whether or how the breach of confidentiality has occurred and there might be costs in doing so.

- There might be circumstances where the publicity disrupts negotiations and, to that degree, the change comes at a potential cost for companies.
- Having to confirm an interest based

*"...what constitutes a rumour....[a]nywhere judgements are required there is a risk of inconsistency which is where the regulatory problems arise."*

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