

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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CORPORATE RETURNS: WORKING ASSETS HARDER

Improved financial returns from Australian listed companies have come from working existing assets harder. Business expansion has not been important. And, despite some improvement in returns, larger industrial companies are barely adding value for shareholders.

The 30 largest industrial companies, measured by market capitalisation, reported an aggregate rise in after tax profit of 12.8% for the year ended June 2003.

The improved profitability was achieved with a 0.4% decline in total funds (debt plus equity) employed. Debt levels declined by 6.5% while book equity was 3.1% higher. Corporate gearing (debt:equity) continued to fall: having previously fallen from 65.1% at the end of June 2001 to 58.0% at the end of June 2002, it dropped another 5.4 percentage points to 52.6%.

Net operating profit after tax (NOPAT) - profit after tax but prior to interest payments - rose by 9.4%. Measured as a percentage of funds employed, NOPAT summarises a company's underlying operational and financial performance. For the year to June 2003, the operating return on funds employed was 8.7% compared with a 7.9% return for the year to June 2002.

Using NOPAT facilitates comparisons with other companies since it removes the impact of financial structuring on a company's profit performance to show the underlying economic outcome.

When compared to a cost of capital, the NOPAT return also shows the extent to which a company is adding value (if the NOPAT return exceeds the cost of capital) or subtracting value (if the NOPAT return falls short of the cost of capital).

The largest Australian industrial companies failed, as a group, to add significant value to the funds which they employed in their businesses. With a cost of debt of 5.2% for the year, a 5.4% risk free rate of return measured by the 10 year bond yield and a 6% equity risk premium, the cost of capital for this group of companies would be approximately 8.6%.

With an operating return of 8.7% for the year, there was little gap between its average cost of funds and the underlying operating performance. In an economic sense, this group of companies barely broke even.

General comments about performance conceal a significant range in outcomes even among this elite level of companies. At one end is Woolworths with a 28% return and well ahead of its cost of capital. At the other end are Mayne and Southcorp, both companies suffering strategic shortcomings, with returns of 1.9% and 2.9%, respectively.

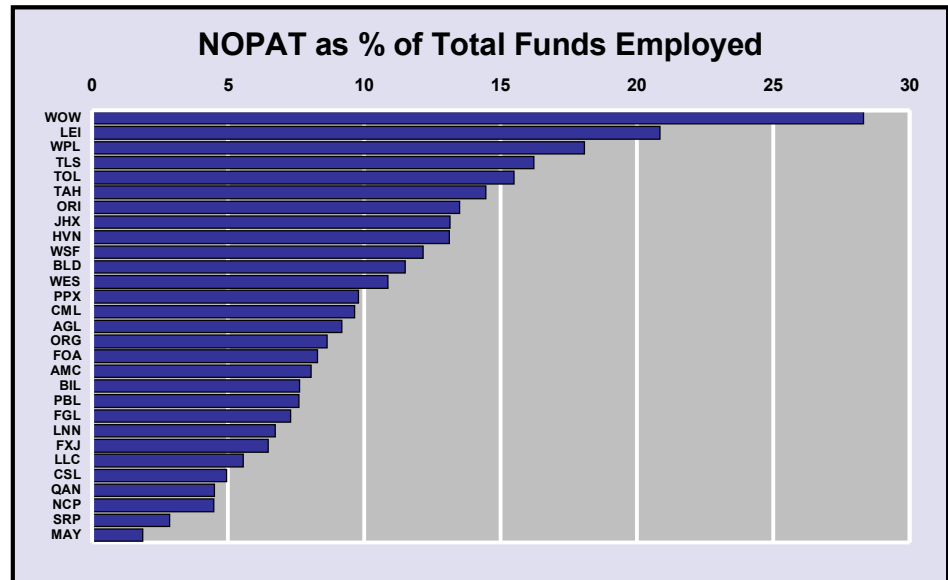
Of the 30 companies covered by this analysis, just on half achieved a return better than the benchmark for the group. Fifty percent fell short.

The aggregate return on equity of 11.7% for the group was marginally better than the 11.4% cost of equity benchmark. However, the margin is so slim that these companies could easily fall short of their target return with even a modest change in the interest

“Companies implementing soundly based strategic growth plans will stand out from the pack and raise their chance of attracting a relatively strong market following.”

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THE WEEKLY CHART SPOT



Source: Company information and *thebigpicture* Economics

There is a wide range in rate of return outcomes among Australia's leading industrial companies. The return on total funds employed varies from a high of 28% to a low of 1.9%. Only half of the companies had a rate of return above the group's average cost of capital. In other words, only 50% of these companies were adding value to stakeholder funds.

THE PRIVATE SCHOOL FEE BUBBLE CONT'D

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return is the value being added by the management to whom I entrust my funds. Ideally, their ongoing employment and how much they are paid will be determined by whether they achieve the targeted return.

How does a private school add value? It can only claim to be adding value if it takes a student potentially with a 60% average, say, and turns her or him into a student who can consistently get 80%. Having a 60% potential student deliver 60% results means that they have added nothing.

That is the real test of whether they should be allowed to attract a growing proportion of the community's resources. In a transparent market those schools adding value should be the ones which can legitimately lay claim to higher fees or public funding. But they do not allow themselves to be judged on this basis.

All too often private schools talk in terms of the inputs such as the science labs, swimming pool and computer facilities and not enough about measuring the outputs. How much does the availability of physical resources add value? If there is a benefit, does it taper off after a point? Is there an

optimum allocation?

How many private schools set performance targets publicly, measure themselves annually, report shortcomings and initiate remedial action all with the full knowledge of parents and other school stakeholders? How many have a strategic plan which is based on the value they add? How many would be prepared to enter a contract with parents for a bonus payment tagged to how much they add value?

Of course, private school principals will no doubt claim that each child is an individual who needs to be nurtured separately. Education cannot be done by the numbers. Perhaps. But at what price?

And what about the use of monopoly power? Schools know that parents cannot change a schooling decision within a matter of weeks. Pushing up school fees with little notice is using economic power aggressively by any standards. It would be regarded as acceptable behaviour in few other industries. Where is the ACCC?

So here we have questions of value delivery, equity, distortions in the pattern of resource usage, aggressive use of monopoly power and a price bubble. Any other industry would attract an enquiry.

"....even the much vaunted housing price bubble is barely sufficient to compensate for the private school fee bubble."

CORPORATE RETURNS: WORKING ASSETS HARDER CONT'D

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rate environment. A fifty basis point change in interest costs in the 2003 year would have eliminated the spread over the cost of equity.

Focusing on the equity return at a time of cyclically low interest rates tends to overstate sustainable corporate financial performance.

Decomposing the equity return into the constituent parts shown in the formula helps to clarify the sources of the higher return. The five components describe the key operating, financial and balance sheet

$$ROE \equiv \frac{\text{net profit}}{\text{pretax profit}} \times \frac{\text{pretax profit}}{EBIT} \times \frac{EBIT}{\text{sales}} \times \frac{\text{sales}}{\text{assets}} \times \frac{\text{assets}}{\text{equity}}$$

structuring factors with an impact on the equity return.

Using this decomposition allows comparisons:

- for the same company across different time periods;
- for different companies, across the same period of time; or,

Lower tax	0.135
Lower interest	0.295
Higher operating margin	0.369
Greater asset efficiency	0.575
Reduced leverage/size	-0.467
Total impact	0.908

Overall, these larger companies were on a relatively conservative course. Management was working the existing assets harder and cutting company debt. Lower tax also contributed.

Relative to their available equity funding and capacity to grow, their asset base shrank. Indeed, the value of total assets fell slightly in each of the last two years. At 30 June 2003, the value of assets was 2.4% lower than at the end of June 2001.

The decision to operate within their potential most likely reflected an uncertain business environment. In some cases, too, poor strategic positioning was curtailing expansion plans and leading to business contraction.

Widespread demands for more effective capital management and more rigorous governance standards might also have

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Equity Return Analysis for Top 30 Industrials

		2002	2003
Tax burden	High ratio implies effective tax minimization policies; 0.70 for Australian corporate rate	<i>net profit/pretax profits</i>	0.670 0.679
Interest burden	Equal to 1 when there are no interest payments	<i>pretax profits/EBIT</i>	0.826 0.848
Return on sales	Operating profit margin	<i>EBIT/sales</i>	0.105 0.109
Asset turnover	Efficiency with which the firm uses its assets	<i>sales/assets</i>	0.818 0.862
Leverage	Measure of financial leverage	<i>assets/equity</i>	2.262 2.164
ROE			0.108 0.117

- for an individual company, against different benchmarks or peer groups.

The table shows the decomposition for the aggregated top 30 industrial companies for the year ended June 2002 and the year ended June 2003.

The 0.908 percentage point improvement from 10.8% to 11.7% in the equity return was driven by:

taken a toll. By making directors more risk averse, these pressures could have led to growth being given a lower priority.

Against this backdrop, there are opportunities for companies that can break from the herd to distinguish themselves. Companies implementing soundly based strategic growth plans will stand out from the pack and raise their chance of attracting a relatively strong market following.

THE PRIVATE SCHOOL FEE BUBBLE

The Productivity Commission should be asked to enquire into private school education in Australia. Why not! After all, it is asked to report on other business sectors where there are examples of pricing irrationality, questionable equity outcomes, use of anti-competitive tactics and concerns about resource deployment.

The Melbourne newspapers reported recently on fees for private schools in inner Melbourne for 2004.

Annual fees are around \$11,000 a year for the upper levels of secondary school – and some are higher. A parent with three children could be facing a bill of around \$275,000 at current prices for the 12 years of their childrens' pre-tertiary education (before uniforms, books, camps, building appeals and trivia nights).

Scarier still is the need for pre-tax income of up to \$570,000 in round numbers simply to meet this cost.

But worse than that is the fees inflation. Private school fees appear to be increasing at around 8% a year. And yet, since 1992, the average rate of housing price increase in Melbourne has been just over 7.5% a year. In other words, even the much vaunted housing price bubble is barely sufficient to compensate for the private school fee bubble.

Of course, there will be little sympathy for the plight of private school parents. People sending their children to private schools are often regarded as wealthy. For some, they are status seekers who do not deserve the sympathy of the rest of the community.

But whether private or public money is being used, a growing percentage of the community's income is being absorbed by these institutions. As a community, are we better off having it this way or would we be better off if the resources were going into public sector education? Are there other private schools which are more deserving but for some reason cannot stake a claim to these resources? Or would we be better off if the spending were directed somewhere else entirely?

That debate has been going on for a long time and is one reason for a public enquiry.

Another reason for an enquiry is that the private school, like the private home, is being priced out of the reach of ordinary people at much the same rate as housing is being taken from them. If breadth of education choice is important then this is a public policy issue deserving further consideration.

Of course, this begs the legitimate question of how to measure whether the private school system is providing any social or economic benefit.

For some, the private school is about encouraging a set of values. For others, it is seen as a stepping stone into spheres of business and social influence. Even these sometimes trivial motivations are worthy of understanding. It would be worthwhile finding out, for example, if there is still workplace discrimination in favour of the privately educated.

There is evidence that the academic results from private schools are superior to the academic results at government-run schools. But what does that mean?

Parents sending their children to private schools might be more highly motivated and generally better able to provide an environment at home which supports learning. Private schools should not be able to claim the benefits of this and, in some perverse failure of the market economy, charge for it. Equally, government schools should not have it held against them.

Private schools need to show they are adding value. The risk is that they simply re-package what they are given in a uniform and demand exorbitant fees for doing so. It is like investing \$1,000 in a company and, twelve years later, only getting back the \$1,000 without any dividends in the meantime. Why bother?

If I invest \$1,000 in a company I expect that it will generate a return of 10-12% a year and when I want to sell my holding I will receive my \$1,000 back. The annual

“And what about the use of monopoly power? Schools know that parents cannot change a schooling decision within a matter of weeks. Pushing up school fees with little notice is using economic power aggressively by any standards.”

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