

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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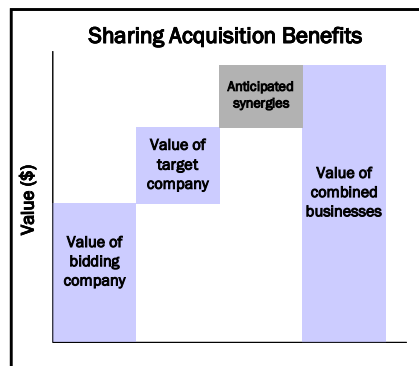
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A TAKEOVER: THEN COMES THE REAL DECISION

Investors should have mixed feelings about a takeover bid for any of their shares. Takeovers might induce higher share prices but, once completed, the investor must choose alternative investments.

There are several current prominent examples of companies being subjected to takeovers. In two cases, potential bids for Goodman Fielder and MIM Holdings, the targets are companies generally thought not to have fulfilled their potential. Both, however, have new generations of management which have been reforming the businesses and promising significant increases in shareholder returns.

The third example, wine producer BRL Hardy, is at the forefront of a major Australian growth industry but has encountered strategic limitations to its own growth. Like the others, it was also suffering a share price much lower than it had once been.



In the case of Goodman Fielder, there is a formal takeover bid which has been rejected by the management which is arguing that the share price benefit of its good work has yet to show through and that the bidder is, therefore, opportunistically taking advantage of a situation which is unlikely to persist.

The MIM situation is different insofar as it is in discussion with a potential suitor. Presumably, after the discussions, the two companies will present an agreed bid to shareholders for their consideration.

The third is different again. BRL's bidder is already a business partner in the group's most significant growth market.

In each case, however, the success of the bid will depend on the decisions of shareholders deciding whether to support or oppose it. Also, in each case, institutional shareholders who hold the bulk of the shares will determine the outcomes. Indeed, they effectively often put companies in play by selling a part of their holding to allow a bidder to build an initial stake in a target. This supports their short term performance.

For private shareholders, the choices in these cases are limited:

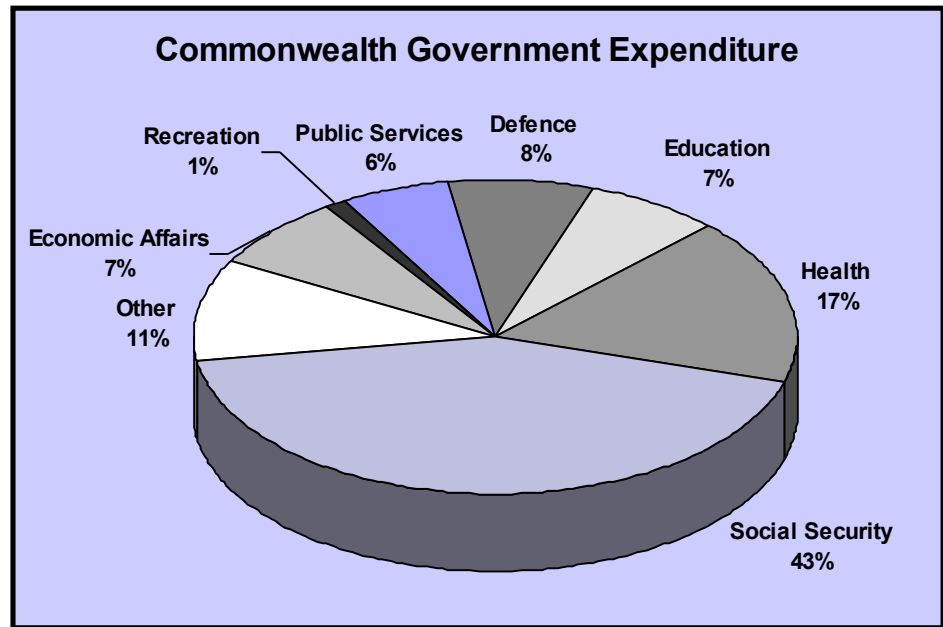
- accept the takeover offer on the terms presented;
- refuse to sell and have the shares acquired compulsorily at a subsequent stage if institutional shareholders accept; or,
- refuse to sell and be forced into a minority position with reduced liquidity, little leverage as a shareholder and without the potential of a bid to support the share price.

Unless there is clear evidence of a substantial proportion of institutional fund managers opposing a bid, it makes sense for a private investor to wait until the closing date approaches and accept with the aim of getting the earliest possible payment for shares.

A genuine investor rarely enters the market in the expectation of a takeover bid. Takeover bids are highly speculative. Most potential bids considered by Boards come to nothing. It is very difficult for bidders to get value from a takeover because the bidding

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THE WEEKLY CHART SPOT



Source: Australian Government 2002-03 Budget

“With the likelihood of a US-led war in the Middle East and with the current Australian government seemingly committed to an active role, the balance of risk would favour the budgeted level of [defence] expenditure being exceeded this year. For related reasons, it also seems likely that defence expenditure will rise more rapidly than expenditure generally in coming years.”

Government defence expenditures were budgeted to be \$13,144 million in 2002-03. If realized, this level of expenditure would represent an increase of 9.4% over the level of defence expenditure in 2001-02.

Although substantially smaller than social security and health expenditures, defence spending, which accounts for about 8% of Commonwealth outlays, is one of the largest single budgetary items.

With the likelihood of a US-led war in the Middle East and with the current Australian government seemingly committed to an active role, the balance of risk would favour the budgeted level of expenditure being exceeded this year. For related reasons, it also seems likely that defence expenditure will rise more rapidly than expenditure generally in coming years.

Since the budgeted surplus for the current fiscal year was already a wafer thin \$180 million (on an accrual basis), without any other changes to the budget, a 5% increase in defence commitments would imply a second successive annual budget deficit.

This would be an unfortunate occurrence since it would increase pressure on other, perhaps more deserving, areas of government activity to justify existing commitments. Most areas of government spending appear to face higher hurdles in demonstrating efficacy than the potent national security justification allowed for defence. A deficit would also signal, after many years of relatively strong growth, a less tractable budgetary situation that would have been envisaged by now.

While the government clings to the symbolism associated with maintaining a budget surplus, ultimately it is unlikely that it will cut back significantly on other spending to achieve its defence aims. It has already learned that expenditure cuts have their political consequences and, having had to reverse many which it had made in its early period in office, is unlikely to repeat the error of political judgment.

Ultimately, therefore, there will only be one way in which to limit the deficit: raise taxes. Of course, the government would not refer to additional imposts as higher taxation. It would most likely try to use increasingly standard forms of political flummery to maintain the budget surplus symbolism. There will be recourse to some form of defence ‘surcharge’ and, dressed up as a national security measure, no one could reasonably object.

A TAKEOVER: THEN COMES THE REAL DECISION CONT'D

(Continued from page 1)

process encourages targets to set up defences, including the break-up of the target, to make the bid as unattractive as possible. Even where there are so-called synergies to be had by combining the target and bidder, the target seeks to have as much of the value of these benefits paid to the existing shareholders as it can, again rendering the transaction less attractive for the bidder whose primary aim is to capture the benefits for its own shareholders.

Most often, bids proceed when:

- a target management has lost so much credibility that shareholders have little expectation of business recovery and a bidder is able to persuade them to sell their shares at a price lower than what the bidder would have to pay for comparable assets elsewhere;
- an existing relationship between the bidder and the target makes it virtually impossible for another party to enter the bidding or for the relationship to be broken and a viable business acquired by a third party; or,
- there is an agreement between the parties that it is in the best interests of the two to merge to achieve their business objectives with management presenting shareholders with a *fait accompli* and an option for both sets of shareholders to maintain an investment position in the combined entity.

The prospective BRL, Goodman Fielder and MIM transactions fit one or other of these categories and, in each case, the target share price has appreciated substantially in response to the potential bid.

In each case, however, investors will be left with cash or significantly different investment situations than they had originally envisaged, if the transactions are consummated. In the case of the BRL transaction, there appears to be a possibility of owning a US based beverage manufacturer and distributor. In the MIM case, there is the prospect of owning shares in a foreign-based resources house. In the third example, the option would appear to be a holding in a highly leveraged Australian listed company with a strong New Zealand influence.

For shareholders electing to accept a scrip offer, there are two key questions to be addressed.

- Is the combined entity capable of gen-

erating a return on the funds employed (that is, equity plus debt, including capital to be raised to fund the transaction) which meets their required rates of return?

- Does the share price after the transaction imply an achievable rate of growth? Or, have extravagant statements made in the course of the bid led to an unachievable rate of growth being factored into the price?

If an investor accepts the cash offer, he is confronted with a parallel set of decisions as he tries to find alternative investments which deliver an appropriate rate of return and whose prices factor in achievable rates of growth.

This might be a blessing if the company being acquired had a poor shareholder return record. Funds can be switched into companies with superior economic returns (an option which should be contemplated in any event). There is a problem, however, if the acquired company is generally well performed. The risk for former shareholders is that they are forced to invest in inferior situations with either lower returns or higher levels of risk.

thebigpicture has categorised companies into one of the following four groups:

- G1: companies with a history of returning better than their cost of capital
- G2: companies which have a history of falling short of their cost of capital and for which there is no evidence of a change in performance
- G3: companies undergoing sufficient change that they could make the transition to the first group within the foreseeable future
- G4: companies which do not fit in either of the first two categories but which might have a new business offering, process innovation or intellectual property discovery.

Investors should think in terms of G1 and G3 companies making up the preponderance of an equity portfolio. G2 companies should be eschewed until, perhaps, there is a change in management or some other signal that it might make the transition to a G3 category. Even then, evidence will need to accumulate first. Similarly, the G4 category might deserve a watching brief to ensure commercialization progress and capital adequacy before an investment is undertaken.

“There is a problem, however, if the acquired company is generally well performed. The risk for former shareholders is that they are forced to invest in inferior situations with either lower returns or higher levels of risk.”

PARKING FUNDS: THE RISK WITH BONDS

Investors using the bond market as a safe harbour while awaiting a return to equities might be incurring some additional risks. Cash might be the place to stay if short-term equity risks are perceived to be too high.

Market conditions are still not attractive enough for an immediate swing into equities. Global geopolitical events remain one important risk. Market valuation, although much improved, remains problematic: there might be another half year of profit rebuilding required to justify current market values (and provide a base for subsequent market appreciation).

However, by mid-to late 2003, the eventuality or outcome of a Middle East war might be clearer, markets might be in bet-

term.

The problem can be illustrated with the accompanying table.

Let's say that an investor purchases Australian government 10-year bonds with a face value of \$100 at the market yield of 5.25 percent on 1 January 2003.

As conditions become more supportive for equity markets, bond yields begin to rise reaching eventually around 6½ per cent which is a level more consistent with likely long-term inflation outcomes and a global economy on a cyclical upswing.

thebigpicture for the week commencing 4 November 2002 outlined the reasons for expecting that yields will tend to this level and that yields below 5.5 per cent will be in the lower end of a likely trading range.

The table shows how, at a yield of 6.5 per cent, the purchased bond would have a value of \$91.20 in June 2003. The coupon would have supplemented the return but selling it at that time would still represent an annualized loss of 12.1 percent.

Over time, interest receipts will compensate for the yield appreciation and, taken to maturity, there will be a positive annual

return. Hence frequent references to bonds being safe havens for investors.

However, for the investor in the short term, any equity investment purchased subsequently to selling bonds will have to compensate for the capital loss associated with the bond purchase before break-even can be contemplated.

There might be an argument, consequently, for an earlier switch to equities if the equity market risk is perceived to be less than the potential bond market loss. Alternatively, retention of cash might be the appropriate course of action.

“The notion of the bond market being a safe haven might be misplaced if the intention is to re-allocate funds to equities at some time during 2003. The safe haven status is only apparent over a significantly longer-term exposure.”

Prices of 10-year Bonds Purchased on 1 January 2003*

Yield	Mar-03	Jun-03	Sep-03	Dec-03	Jun-04	Dec-04	Dec-05
4.75	103.9	103.8	103.7	103.6	103.5	103.3	102.9
5.00	101.9	101.9	101.8	101.8	101.7	101.6	101.5
5.25	100.0	100.0	100.0	100.0	100.0	100.0	100.0
5.50	98.1	98.2	98.2	98.2	98.3	98.4	98.6
5.75	96.3	96.4	96.4	96.5	96.7	96.8	97.2
6.00	94.5	94.6	94.7	94.8	95.1	95.3	95.8
6.25	92.8	92.9	93.0	93.2	93.5	93.8	94.4
6.50	91.1	91.2	91.4	91.6	91.9	92.3	93.1
6.75	89.4	89.6	89.8	90.0	90.4	90.8	91.7
7.00	87.8	88.0	88.2	88.5	88.9	89.4	90.4

* Based on a \$100 face value, \$5.25 coupon, paid twice a year using a bond pricing model.

ter balance with profitability and the momentum of business activity could be improving. Circumstances might justify a higher equity weighting.

The notion that the bond market is a safe haven while awaiting these more propitious conditions might be misplaced if the intention is to re-allocate funds to equities at some time during 2003. The safe haven status is only apparent over a significantly longer-term exposure.

This is particularly so where bond yields are below where they will be in the longer