

# thebigpicture

guideposts for the private investor

Week Commencing 4 October 2004

## **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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## COMPANY RESULTS: RETURNS UP

Australia's larger listed companies significantly improved their financial performance in the past year. They continued their relatively conservative approach, relying more on better use of existing assets than expansion of their asset bases to boost results.

The largest 35 non-financial industrial companies listed on the Australian Stock Exchange reported an aggregated 18 per cent rise in profit after tax for 2003/04.

This analysis is based on companies which had reported results for their 2003/04 year by the end of September. It excludes companies with December balance dates, for example, as well as financial services and resources companies which might have already reported.

The acceleration in earnings growth was consistent with the economy-wide profit performance reported by the Australian Bureau of Statistics and discussed in last week's edition of *thebigpicture*.

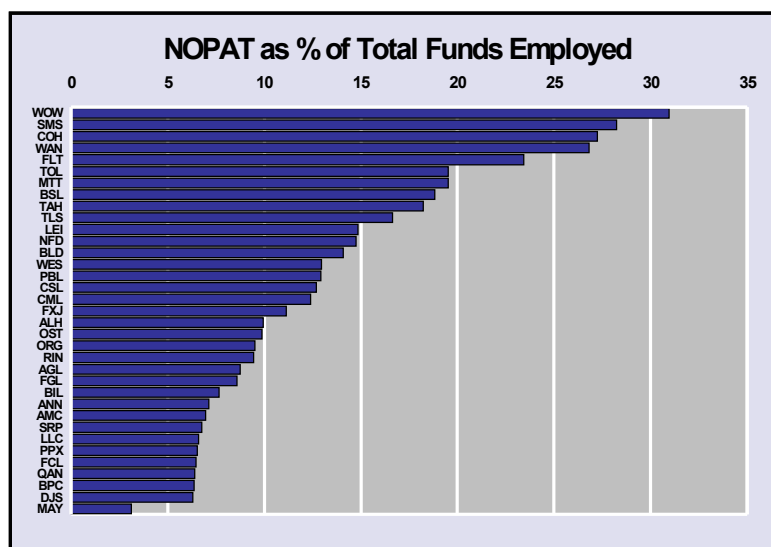
The improved profitability among the listed stocks was achieved with a relatively small increase in funds employed of 3.5 per cent comprising a 2.4 per cent increase in debt and a 4.2 per cent rise in shareholder funds.

Gearing fell for the fourth consecutive year. The 35 company aggregate gearing (debt/equity) was 61.5 percent at June 2004 compared with 62.5 percent at June 2003.

In making stock selections, *thebigpicture* has two key tests of performance:

- whether the return on funds employed exceeds the company's cost of capital (i.e. there is a positive return spread); and,
- whether this return spread is rising.

*“With a continuing improvement in company performance in recent years, 22 out of 35 companies exceeded their costs of capital in the past year.”*

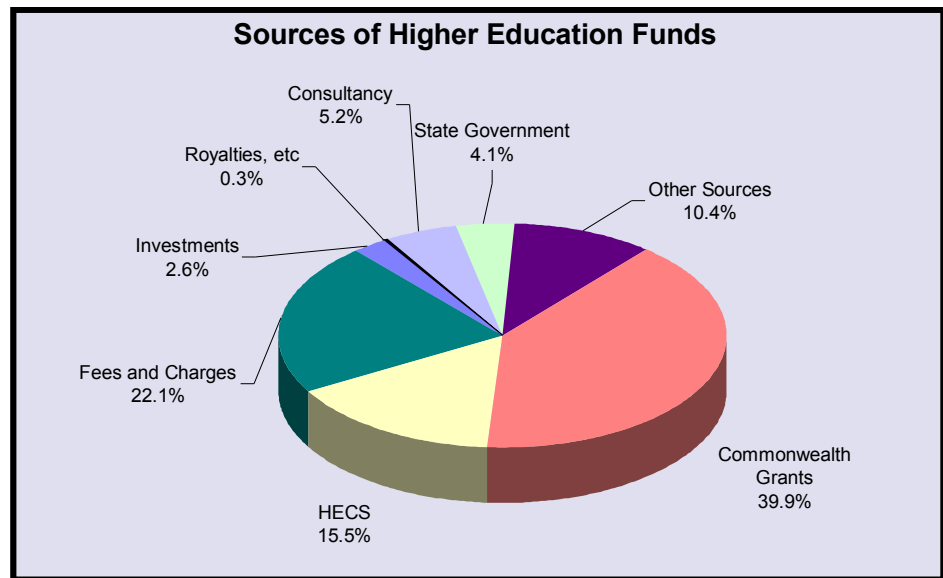


Calculation of the return is based on "NOPAT", the net operating profit after tax. The NOPAT measure and its relative merits has been discussed in earlier editions of *thebigpicture*.

It excludes the effect of borrowing costs from pre-abnormal reported profits to allow judg-

(Continued on page 3)

## THE WEEKLY CHART SPOT



Source: Commonwealth Department of Education

*“Having radically altered the way tertiary education is funded, the Howard government has initiated a substantial departure from State government funding of local public schools ....”*

With Australia’s free universities now a faded memory, extensive changes to primary and secondary school funding have been signaled during the election campaign.

Figures from the Commonwealth Department of Education show a continuing decline in the importance of Australian government grants as a source of funding for tertiary education. In 2003, Commonwealth grants accounted for just under 40% of higher education funding. The Higher Education Contribution Scheme (HECS) contributed an additional 15½% of funds. Fees and charges had risen to 22%.

Having radically altered the way tertiary education is funded, the Howard government has initiated a substantial departure from State government funding of local public schools with its initiative to directly fund them on the basis of bids lodged by parents in association with school principals.

The mould is being broken. The lesson from the tertiary education experience is that once the first cracks appear, the old system is overwhelmed quickly by the more radical pricing mechanisms which are introduced to allocate resources, including loans, non-funded places for foreign students, external funding through sponsorships and performance based pay for teachers.

One MP suggested recently that state schools should be able to charge fees if it meant better resources for students. After discussing this proposal with her colleagues and party officials, she recanted protesting that she had been misrepresented. Quite clearly she regretted making her statement but her expression of views seemed quite straightforward. She thought alternative funds should be used if they were available.

Despite strong adherence to the prevailing model which prizes equality at the expense of better facilities for a few, the electorate seems prepared to change the way schools are funded. Whichever party is elected on 9 October, changes to primary and secondary education funding arrangements seem set to occur.

In the past few weeks, we have gone well past a debate about whether non-government schools should be publicly funded. State governments are being put on notice that education outcomes are too important to the national well-being for them to be ignored by the Commonwealth and everyone’s vote is too important to exclude anyone’s children.

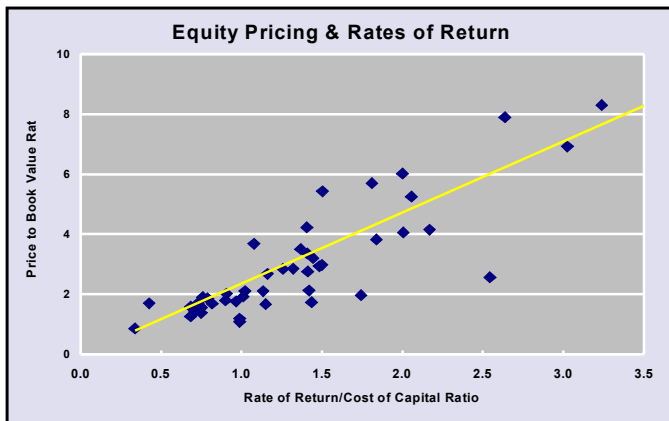
There is a growing push for more results oriented funding. With concerns that some teachers are not up to the task, it is a short step to tie funding to teaching performance.

Extrapolating the tertiary education experience, it might not be too great a stretch to require foreign students and students of non taxpayers to pay their way. That would establish the basic price of education. The principle would be established and we would be well on our way to having fees in public schools. ■

## COMPANY RESULTS: RETURNS UP CONT'D

(Continued from page 1)

ments to be made about underlying operating performance undistorted by the effects of debt. Changes in debt levels can raise or lower reported profit without there being any change to the underlying performance of a business.



In *thebigpicture* analysis, differences in gearing are reflected in the costs of capital: relatively highly geared companies typically have a lower cost of capital than companies with relatively low gearing.

The bigger the positive difference between the NOPAT return and the cost of capital shows the extent to which a company is adding value to the capital employed in the business.

From this perspective, management can add value by:

- increasing operating efficiency;
- increasing sales at existing margins;
- reducing debt;
- lowering the cost of debt;
- increasing the proportion of debt relative to equity through capital management initiatives such as a share repurchase.

Across the companies considered in this analysis, the average NOPAT return was 11.6 per cent compared with 10.7 per cent in 2002/03.

Based on *thebigpicture* analysis, the average cost of capital against which to compare this return is 8.6 per cent implying that this

corporate group has been adding to value through its activities.

The average return does, however, conceal a wide range of outcomes, illustrated in the chart on page one, varying from the 31 percent return generated by Woolworths down to the 3.1 per cent at Mayne Group.

With a continuing improvement in company performance in recent years, 22 out of 35 companies exceeded their costs of capital in the past year.

While this measure of performance is not widely reported in the financial press, it is a key equity price indicator.

The chart shows how the spread between the rate of return and the cost of funds (on the horizontal axis) varies with the premium being paid by the market (in this case measured as the excess of market price over book value). A higher spread is usually associated with a larger market premium.

The significance of this framework for stock selection is that companies with a rising return spread have a higher probability of above average capital appreciation.

The improved financial performance enhances the value of these companies for investors. The higher level of operating profit would be worth an additional \$33 billion or 17 percent providing a foundation for the 16 percent rise in the market over the past 12 months. ■

*“The improved profitability among the listed stocks was achieved with a relatively small increase in funds employed of 3.5 per cent comprising a 2.4 per cent increase in debt and a 4.2 per cent rise in shareholder funds.”*

### Conservative Balance Sheet Management

Lower financial leverage is an indicator of how conservative management has become, somewhat surprisingly in an environment of lower interest rates. Unfortunately, the reticence to use their balance sheets to fund expansion undermines the value to be had from investing in listed equities.

Nonetheless, not everyone would be encouraging companies to expand more aggressively. Listed companies have generally had a poor track record when it comes to growth outside their existing operations which has too often come at the expense of returns. From this perspective, investors might be better placed if companies eschew significant expansion opportunities which transform the balance sheet in the short term.

That is why so many are simply restructuring their balance sheets to extract more of the potential value. With the cost of debt lower than the cost of equity, an increase in gearing will lower the average cost of capital. From a value sensitivity viewpoint, a one percentage point drop in the cost of capital would need a 50% rise in debt and would be equivalent to an 8.3% rise in operating profit.

## EQUITY RETURN ANALYSIS

Looking at value from the perspective of the return on equity also highlights how managers have been working to get more from physical assets but have been reluctant to use gearing aggressively to add value.

The return on equity also shows a full percentage point improvement from 15.2 per cent to 16.3 percent.

The equity return can be decomposed into five constituent parts to clarify the sources of the improvement. The five components describe the key operating, financial and balance sheet structuring factors which have an impact on financial performance.

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

Each of the components is defined in the table below.

and asset efficiency.

The latter would most likely be a superior investment alternative since its business performance implies more managerial and operational skill.

Using the decomposition shown in the formula allows comparisons:

- for the same company, across different time periods;
- for different companies, across the same period of time; or,
- for any individual company, against different benchmarks or peer groupings.

The table below shows the decomposition analysis for the sample group of 35 industrial companies for the three years ended 2002, 2003 and 2004.

In summary, the decomposition shows for the last year:

- slightly lower tax provisions;
- lower interest payments;

*“The improved financial performance enhances the value of these companies for investors. The higher level of operating profit would be worth an additional \$33 billion or 17 percent...”*

		2002	2003	2004	
<b>Tax burden</b>	High ratio implies effective tax minimization policies; 0.70 for Australian corporate rate	net profit/pretax profits	0.686	0.695	0.708
<b>Interest burden</b>	Equal to 1 when there are no interest payments	pretax profits/EBIT	0.840	0.851	0.864
<b>Return on sales</b>	Operating profit margin	EBIT/sales	0.087	0.097	0.104
<b>Asset turnover</b>	Efficiency with which the firm uses its assets	sales/assets	1.212	1.150	1.165
<b>Leverage</b>	Measure of financial leverage	assets/equity	2.610	2.315	2.199
<b>ROE</b>			0.158	0.152	0.163

Clarifying the sources of performance variation can be valuable in judging the sustainability of company returns. For example, two companies might have identical returns based on their reported results. However, one might have a return driven by aggressive tax minimization and low interest charges while another might have relatively high operating margins

- improved operating margins;
- assets being worked harder; and,
- reduced financial leverage.

All but the fifth element, greater financial leverage, were working in favour of higher returns. ■

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