

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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PRIVATE EQUITY: MORE TO COME?

Big gains are being realised by private equity investors as they sell some of their holdings through public listings. Many of the high profile transactions are not repeatable. Returns reflect additional risk and are likely to decline.

Strong returns from private equity investments have been highlighted in recent weeks through several initial public offerings in companies whose major shareholders have been private equity funds. Newspaper reports suggest that the vendors of Pacific Brands and Just Group, two of the more conspicuous examples, will receive annual returns of 25% and 85%, respectively, for the two and a half years they held their investments.

Of course, these are just two examples of IPO's in the current market. There are also banks holding assets for disposal (such as Zinifex aka Pasmenco) and private owners (such as Colorpak, a current IPO) seeking to realise some of the value from the businesses they have built.

The appetite for new offerings, already alive and well, is being stoked by some high profile campaigning. Companies with strong brands can exercise a particular advantage in coming to market. The Pacific Brands listing, for example, has been accompanied by a major advertising campaign ostensibly to promote its product portfolio but having the handy by-product of grabbing a larger share of investor attention than its financial details alone could normally command.

The campaign for Pacific Brands has been reminiscent of those for Woolworths and David Jones, two similarly high profile names, disorganised after the failure of their parent companies in earlier years.

thebigpicture flagged two reasons recently (in *IPO's: Track Records Count Most*) for being cautious about IPO's, whatever their source.

- Risk profiles differ considerably. Returns from IPO's are influenced heavily by the pre-IPO history of the companies being launched on the exchange. The weaker the financial history of a company the more likely it is to provide poor shareholder returns in the future. See the contrast between Woolworths and David Jones.
- Short-term gains for new buyers are becoming less likely. Vendors are better able to assess what the market will bear by having institutions bid for stock before setting the offer price. They can limit the gains for buyers and correspondingly maximise the return for themselves.

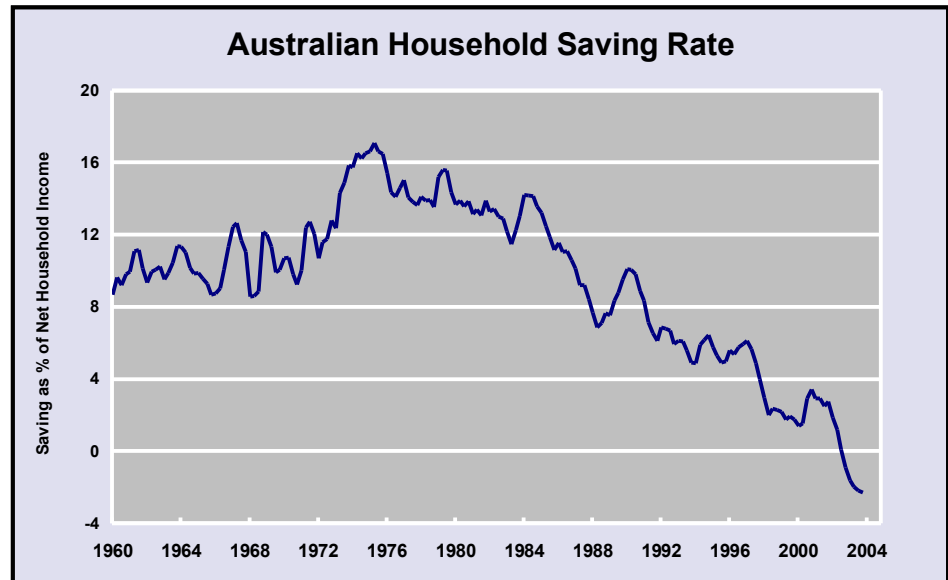
A third relevant consideration is the general warning to be wary of market fads. This

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	1970s	1980s	1990s	2000s Low	2000s High
Inflation	7.4%	5.1%	2.9%	2.5%	2.5%
Target return on bonds	3.5%	3.5%	3.5%	2.5%	3.5%
Target equity premium	3.5%	3.5%	3.5%	2.5%	3.5%
Target return on equities	14.4%	12.1%	9.9%	7.5%	9.5%
Target private equity premium	5.0%	5.0%	5.0%	3.5%	3.5%
Target private equity return	19.4%	17.1%	14.9%	11.0%	13.0%

THE WEEKLY CHART SPOT

Australia's household saving rate declined for the eighth consecutive quarter according to data from the Australian Bureau of Statistics for the December quarter. In the shorter term, use of savings is supporting consumption spending. However, the historically low level of household savings imposes a long-term constraint on investment and growth. By tapping into their savings, consumers are also putting a lid on their future consumption spending growth especially if they later seek to rebuild their savings levels.



Source: Australian Bureau of Statistics

PRIVATE EQUITY: MORE TO COME? CONT'D

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always sound advice for the potential investor would have made him sceptical of companies investing in China in the early 1990s and, later, might have saved him from the frenzy over information technology stocks.

In a smaller but similar way, private equity and licensed investment companies are two fads in the current market to be treated with scepticism. A third highlighted recently in *thebigpicture* has been use of share purchase plans using large discounts to entice investors to subscribe new funds.

All of these fads reflect prevailing market circumstances, namely, a growing appetite for alternative investment opportunities as existing companies become fully valued. The sale by private equity investors of businesses purchased in less buoyant circumstances is a significant pointer to the market being fully valued.

Many of the sales of private equity investments now being made are of assets which were purchased in significantly different economic times. The Pacific Dunlop instance, from where Pacific Brands emerged, is illustrative.

Pacific Dunlop was a company which had consistently failed to generate adequate returns from its various businesses. The source of its failure was thought to be an

inappropriate business model. A broad ranging conglomerate was supposedly too difficult to manage. Lead smelting, work clothes, tyres, rubber protective products, car batteries, lingerie and branded food-stuffs did not seem a comfortable mix so there was considerable pressure for it to restructure its exposures.

Whatever the reason, its persistently depressed share price caused shareholder unrest and a disposition by management and directors to sell assets rather than work to improve their performance. The low share price set a benchmark for the value of the assets comprising the enterprise as they were marketed to investors and trade buyers.

The current returns reflect more the environment in which the original investments were made than current conditions. It would be a mistake to believe that the advertised returns from such peculiar circumstances can be repeated consistently. The returns being reported so prominently are the returns available from selling today not from buying now.

There are several reasons why the returns from private equity investment will tend to be higher than for other equity investments.

- Private equity investors typically seek a significant additional return

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GETTING BULLISH ABOUT PRIVATE EQUITY CONT'D

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over what an investor in listed equities might target to compensate for higher risk due to holding illiquid assets.

- Aggressive use of financial clout when buyers are scarce can deliver a low entry price.
- Investors who are subject to less scrutiny than equity and superannuation fund managers reporting daily valuations on listed investments can afford a longer time horizon and have added flexibility in choosing investments.
- By offering management a substantial equity stake, they realign incentives in their favour to maximise the speed and effectiveness of any necessary restructuring.
- Private equity investors will take a more active role than passive fund managers in setting management targets to ensure a rapid build in value which can be identified readily by public markets or potential trade buyers.
- Private equity investors, often with strong industry expertise, may have a better sense of value than trade buyers making the occasional investment. They can often have the confidence to commit funds before the economic cycle turns when others are more risk averse.

In any event, the macroeconomic environment is pushing private equity returns lower. In the early 1990s, with Australian bond yields hovering around 10% and an assumed equity risk premium of 6%, in-

vestors in listed equities would have been seeking a return in the vicinity of 16%. Private equity investors would have been seeking a return some five percentage points higher.

With economic conditions now more business friendly, there are fewer high-profile distressed assets from which to choose. Moreover, with inflation now thought to be sustainably lower than in the early 1990s, bond yields are close to half what they were in mid 1991. Further analysis undertaken since then also points to the equity risk premium being lower so that the required return from listed equities would be around 10% rather than 16%.

The premium being sought for private equity has been reduced for similar reasons to around 3.5% so that the overall annual target return is around 13.5%, some seven percentage points lower.

The table on page one highlights a similar trend in the larger US private equity market from where there are increasing flows of funds to Australia.

The message from these numbers is threefold:

- private equity investments will tend to deliver better returns than listed equity investments;
- the difference in returns has been narrowing; and,
- whatever the difference, it reflects the additional risk in one class of investment over the other.

1. Steven Rattner, Michael Huber & Stacey Harris, "What Are the Appropriate Rates of Return for Private Equity? Do Buyouts Really Produce Excess Returns Over Public Markets?", Institute for Fiduciary Education.

"The current returns reflect more the environment in which the original investments were made than current conditions.... The returns being reported so prominently are the returns available from selling today not from buying now."

ECONOMIC POLICY: NOT FOR US CONT'D

(Continued from page 4)

sponsibility of having to conduct economic policy themselves. That being the case, the temptation to use the available fiscal resources to further political interests has become overwhelming.

This is the new fiscal principle: use taxes before your political opponents can earmark them to shore up their own electoral fortunes.

The emergence of this more pragmatic policy approach across all parties has meant little constituency building for targeted long-term fiscal policy outcomes. Notwith-

standing the occasional document from the Treasury which reports dutifully on the fiscal outlook and the importance of a commitment to save more, budget surpluses as part of a programme to rebuild national savings are no longer a serious discussion in Australia.

Subtly, and without legislation, all parties have agreed that potential surpluses will be used tactically to support electoral outcomes. Liberals, Nationals, Labor, Democrats, Greens and others are now looking for the most electorally effective way to deliver the largesse they have carved out for themselves.

ECONOMIC POLICY: NOT FOR US

The Reserve Bank is unequivocally Australia's primary economic policy-maker. Political leadership is now barely relevant to economic outcomes, a change most politicians are relishing. They do not want to be responsible for economic policy.

The two principal protagonists on the national political stage seem to be muscling up to one another in preparation for the national election to be held some time later this year.

Picking a national leader would have once had economists and political analysts ruminating at length over what it meant for economic policy outcomes.

However, the Labor Party's radical experiment with the election of Mark Latham as its new leader and prospective alternative Prime Minister late last year seems to have mattered little.

Earlier in the year, within the Liberal Party, there was a choice between the current Prime Minister and one of Australia's longest-serving Treasurers. Somewhat against expectations, Prime Minister Howard decided to stay indefinitely. The Nationals went through a less noticed reflection on their leadership without change.

In none of these cases did the choice, or even the uncertainty leading to the choice, cause the slightest anxiety within investment markets.

One reason for the restrained market reaction is that economic policy is now out of the hands of the politicians. Last December, on the very day the alternative Prime Minister was being chosen in Canberra, the Reserve Bank was deciding to tighten monetary policy without reference to politicians on either side of the Parliament.

This suited everyone just fine. In Canberra, debate on interest rate policy is regarded as undesirable since it invites speculation about alternative outcomes or, worse, might imply criticism of the Reserve Bank itself.

The Bank's independence is sufficiently well entrenched for markets to believe

that the critical inflation and growth outcomes will not be changed by personality movements at the head of the political process.

Another reason for the absence of investment market interest in the political leadership is a strong policy convergence across parties. There is no longer any choice between macroeconomic outcomes at the political level. Even the conservative side of politics has adopted its own version of 'tax and spend' fiscal policy, a point on which it had traditionally chided its opponents but on which there is now no practical difference.

As the next election approaches, there are gathering signs that the government will use rising tax receipts to placate interest groups rather than build a budget surplus. This tactic worked very effectively for the government prior to the last national election as it set about restoring its slipping electoral fortunes. Its duplication is hardly surprising.

From once being staunch advocates of building government budget surpluses, the Prime Minister and his Treasurer will now venture no further than a view that there will be no deficits.

At the same time, the primary argument for conservative fiscal management remains, namely, the need to build the national savings rate.

Consumption exceeded household income for the seventh consecutive quarter according to the national accounts data released on 3 March. The household saving rate was nearly nine percentage points higher ten years ago when this was a more widely discussed matter of public importance.

Fiscal policy had never been free from electoral politics. However, a newly emerging set of fiscal and political principles is being embraced by all parties.

Its genesis is the idea that monetary policy is the primary cyclical economic policy tool. Having passed its conduct to the Reserve Bank, politicians have freed themselves, in their minds, from the re-

"This is the new fiscal principle: use taxes before your political opponents can earmark them to shore up their own electoral fortunes."

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