

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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AMCOR: BOXED-IN BY CIRCUMSTANCES

Amcor's position in the industrial value chain might have had something to do with its recently disclosed trade practices predicament.

Amcor manufactures hard containers for drinks and foodstuffs as well as a wide range of soft packaging in Australia, Asia, north America and Europe. It is the largest global manufacturer of some classes of packaging for consumer goods but lacks enough economic clout to sustain targeted financial returns.

In none of the last 15 years has Amcor's financial performance been good enough to beat its estimated cost of capital, the key performance benchmark for value-oriented investors, producing a negative return spread each year.

Amcor's part in the end product can enhance the consumer's experience and facilitate branding for marketers such as Coca-Cola, Pepsi, Nestle and Phillip Morris. However, the fundamental purchase decision by a consumer is based on criteria not directly related to any involvement in the process by Amcor.

The Amcor output, no matter how conspicuous as part of a final product is of secondary importance to consumers when they make a purchase decision.

Amcor's contribution is a cost to the manufacturer. The cost is a direct material cost as well as an indirect one with more bulky packaging adding to transport costs both for the finished good and at earlier stages when intermediate goods must be moved.

There is a permanent motivation for the consumer marketing companies to reduce the cost of packaging by cutting the quantity used or changing the production processes to modify how it is integrated with the final product.

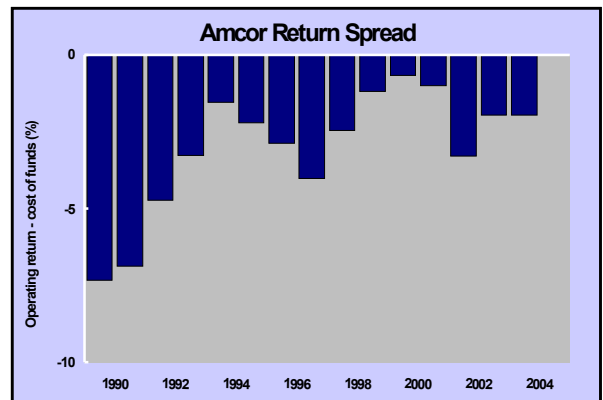
The PET bottle, of which Amcor is the world's largest manufacturer, is illustrative of the issues. PET is attractive because it is a lightweight alternative to glass or metal containers. Moreover, its two-stage manufacturing process improves its economics. The initial forming of the PET module can be done at a remote location with large-scale production enabling economies of scale. Because the modules are small and light, transport costs can be reduced.

The PET module can be stretched and formed into the 'bottle' as part of the manufacture and packing of the soft drink enabling a seamless production process.

Since consumers will not identify Amcor as having contributed any value to the final product, the drink manufacturer, in this case, is always keen to threaten the incumbent PET supplier with a competitor, including the possibility of in-house manufacture.

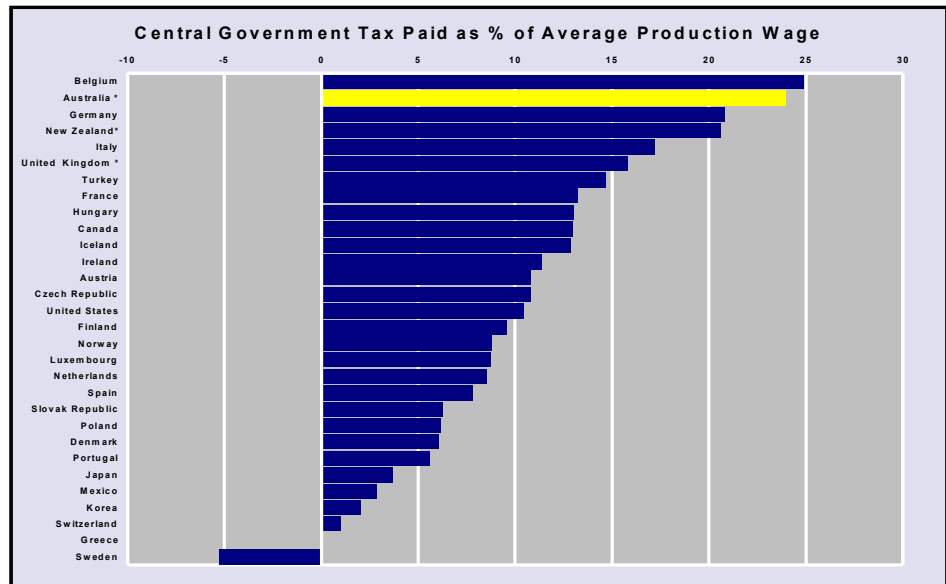
The effectiveness of this threat depends on other potential suppliers having sufficient economies of scale. This is where Amcor has an advantage. Because it has become a

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THE WEEKLY CHART SPOT

“...elsewhere, a higher proportion of taxes is levied by other levels of government and through specific purpose levies.”



Source: OECD

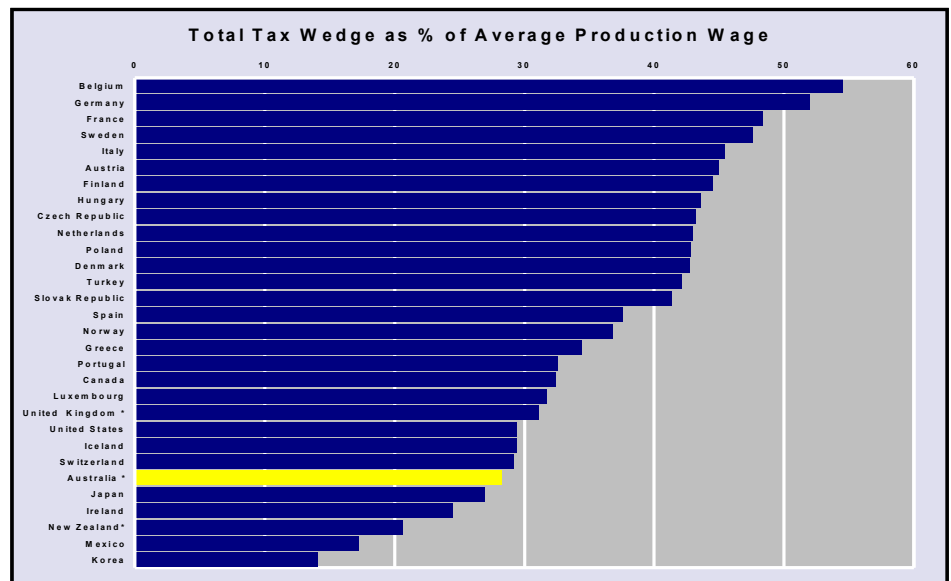
OECD tax analysis shows why Australians might feel overly taxed but why we still rank relatively low when the tax burden is formally measured.

The chart at the top of the page shows a tax burden ranking for an average production worker based on how much tax would have been levied in 2003 by the central government in each of the 30 countries covered. In Australia's case, the production worker is someone with an annual income of \$50,732 in 2003.

On this basis, the Australian worker, highlighted in yellow, suffers the second highest tax burden. This is consistent with the general perception of Australians as having a relatively high tax burden.

However, political structures differ from country to country and, elsewhere, a higher proportion of taxes is controlled by other levels of government and through specific purpose levies.

The second chart shows the tax burden ranking when taxes from all layers of government are included. Now, the tax spread narrows considerably. The average jumps from 10.2% to 36.4% but the Australian burden drops to the sixth lowest (again highlighted in yellow) because, in Australia, the added levies account for only an additional 4.3 percentage points of tax.



AMCOR: BOXED-IN BY CIRCUMSTANCES CONT'D

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global player, it does have size on its side. Other potential suppliers will, at best, be able to match it for scale but not beat it.

Size also has an impact on innovation capacity. Having a global presence probably means that it is abreast of the latest technology and able to continually offer customers cost lowering opportunities.

However, having its financial performance available for everyone to see also disadvantages Amcor. All its customers will have teams of people charged with finding ways to extract more cost savings from their packaging suppliers. Among marketers of consumer goods, achieving 'logistics and supply side economies' is very frequently a euphemism for taking the baseball bat to packaging suppliers in periodic price negotiations.

In this business environment, it becomes impossibly hard to achieve consistently acceptable, let alone above average, fi-

nancial returns. Doing well is an open invitation for customers to renegotiate contracts to achieve more favourable outcomes.

Amcor's financial returns depend on being able to hold the line in pricing negotiations and hoping that competitors will eschew attempts to boost volumes (to lower their own unit costs) by conceding prices.

It is hardly surprising that managers are tempted to control some of these commercial pressures if they see the opportunity.

Whether or not there is any wrongdoing in the case currently getting front page attention is not so relevant here. There is a bigger picture. It is a set of pressures peculiar to companies located in these parts of the value chain.

For an investor, an understanding of where a potential investment sits in the value chain conveys something about the risks it faces and the potential profit that might be sustainable. ■

DIRECTORS TAKE A STAND ON VALUE CONT'D

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commodity price cycle when investors were at their most vulnerable.

In the case of MIM, too, there were credibility issues. MIM had consistently disappointed investors over many years by failing to make the progress which its executives had foreshadowed.

Non-executive directors decided that they would not support the executives and conceded the Xstrata valuation with little fight. For them, the execution risks were too great. The lower risk course was to deliver cash for the shareholders.

At the end of the day, delivering shareholders cash in the hand reduces risks for directors. It will always be very hard to prove subsequently that shareholders would have been better off not accepting, not least because the company will no longer be there to make the point.

To make these decisions, directors need a firm view about the value of the company for which they are responsible. Directors must be able to communicate this to shareholders and the broader investment market.

To the extent that there is a gap between the view of directors and the market, directors have failed and need to look at how

they can communicate more effectively. Sometimes, the independent expert fulfils this role on their behalf.

The directors of National Foods are showing refreshing confidence in the value of their company by backing their judgement about what it is worth and not opting for a report from an independent expert.

More broadly, the prospect of a target fighting off a bidder should be a welcome sight for investors.

Successful bids raise market values and shareholders sometimes look forward to them to deliver better portfolio performance. However, once completed, investors are left with the cash and another choice: which company is sufficiently attractive as an investment option to take the place of the one which has been taken over?

The ideal for investors is to have occasional bids add some market tension so that stock prices can be pushed closer to their fundamental valuations if gap-merge. Ideally, too, bidders should fail to get control so that well-run companies can stay in the hands of the public helping to sustain the depth of the Australian market and maximising the choices available for investors selecting stocks for their portfolios. ■

“There is a permanent motivation for the consumer marketing companies to reduce the cost of packaging by cutting the quantity used or changing the production processes to modify how it is integrated with the final product.”

DIRECTORS TAKE A STAND ON VALUE

National Foods showed that there is a different way of handling an unwanted takeover bid. But it requires directors to be confident about the value of their company. Few appear to be.

National Foods has received an unwanted bid for its shares from Fonterra, a large New Zealand based dairy company. As is usual, incumbent directors have tried to disarm the bidder by claiming that it has failed to adequately value their company.

In part, this is a standard opening tactic by directors to force a higher bid whether or not they believe that the company is worth more than is being offered.

Directors will also sometimes invite an independent expert to opine on the value of the company, although they run the risk of the expert confirming the price placed on the company by the bidder.

Usually, the independent expert will suggest a range of prices within which a bid should fall to fairly value a target. The range will reflect alternative valuation methods, including:

- some form of discounted cash flow model based on current profitability and prospective growth rates;
- an analysis of valuations by broking analysts who have been following the company;
- using market values of comparable companies within Australia;
- using market values of comparable companies outside Australia particularly when there might be a geographic overlap in markets being serviced;
- assessing a break-up value based on what component parts of the company might be worth in the event that its divisions could be separated and sold independently; and,
- deriving a value which includes synergies from combining the bidder and target with the benefits from the combination being attributed to the target (without which they would be unattainable).

Sometimes, not all of these methods can

be applied because of the structure of the industry. Occasionally, too, the independent expert may not be privy to information relevant to a transaction value.

This might happen when companies are making operational changes. A mining company might be reappraising its reserve base and reworking its operating costs to maintain its competitiveness. Similarly, a manufacturing company might not be operating at its optimum and might be planning to significantly improve its cost performance.

Such developments might not be sufficiently advanced to have been disclosed to the market.

This leaves the directors of a target company with an awkward choice: announce the new developments prematurely or keep to the timetable that would have been followed normally.

Credibility is sometimes stretched when publication of a new source of value coincides with an outside bid. For it to have an impact, an announcement at this stage requires considerable confidence among shareholders in the integrity of directors.

There is also some risk for directors. There have been examples of directors rejecting a bid (or advising against it) and suffering reputational and financial losses later when markets have turned down or when they were unable to deliver the improved performance they had promised as part of a takeover defence.

GIO directors arguing against the bid from AMP in 1998 is probably the classic example of what can go wrong and how advisers and directors can be held liable for the losses shareholders suffer from retaining shares at the urging of directors.

The takeover bid for MIM Holdings by Xstrata showed the other extreme in the way directors can react. In that case, the chief executive of MIM argued vociferously that the Xstrata bid undervalued the company because it did not take account of changes underway but which had yet to become evident in earnings. The bid was also being made near the bottom of a

“...the prospect of a target fighting off a bidder should be a welcome sight for investors.”

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