

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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FINANCIAL REPORTING: WHAT TO LOOK FOR

Deciding what to look for in the mountain of information which comes with the annual reporting season is a challenge for an investor. Here are some guideposts to help take the value investor to the peak and back safely.

To accord with ASX listing rules, companies with a June year end should report their annual financial performance by the end of August, a tighter timetable than the 75 days allowed in earlier years. For practical purposes, this means all companies, except those with unconventional balance dates, will announce their results within a four to five week window.

For investors, the task of differentiating sense from nonsense is made harder over this short span of time by the generally confused reporting of what constitutes worthwhile information.

We see often, for example, references to "record earnings". But with inflation supplementing volume growth and cost improvements to push profits higher, not setting a record might be the more telling outcome.

In other places, you will see references which emphasise the size of the profit (e.g. Telstra's \$4 billion) in isolation from any other numerical guidepost. Commentators rarely distinguish between a \$100 million profit requiring \$1,000 million of funding and one needing \$50 million, a critical difference for an investor.

If you read broker research, the emphasis might be more on whether the reported profit was better or worse than expected. Too often broking analysts will confuse what is important with how accurate their forecasts were or why their inaccuracy should be excused.

In other places, the growth in profit compared with last year might be emphasised. Elsewhere, EBIT, earnings per share, operating margin, dividends or cash flow, among a host of other measures, might be highlighted as apparently significant indicators of corporate performance.

How could all these matter and, if they do, how can people managing their own equity investments possibly keep pace with the information flow?

Thankfully, all these do not matter and it is possible (and desirable) for a private investor to establish a set of guideposts against which to judge company performance when

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What to look for....

		Year ended	
		2003	2004
①	Profit after tax	481.9	569.2
②	Net interest paid	54.5	71.1
③	Opening debt	1,317.3	885.9
④	Opening equity	3,410.1	3,765.1
Calculate			
	NOPAT ¹	538.0	625.4
	Funds employed ²	4,727.4	4,651.0
	Rate of return ³	11.0	13.0
	Cost of capital ⁴	10.0	10.0
1. PAT + interest paid – tax saving from interest paid at 30% rate			
2. Debt + book equity			
3. NOPAT as % of funds employed			
4. Weighted cost of funds based on current debt/equity structure, debt servicing charges and risk free rate of return + risk premium			

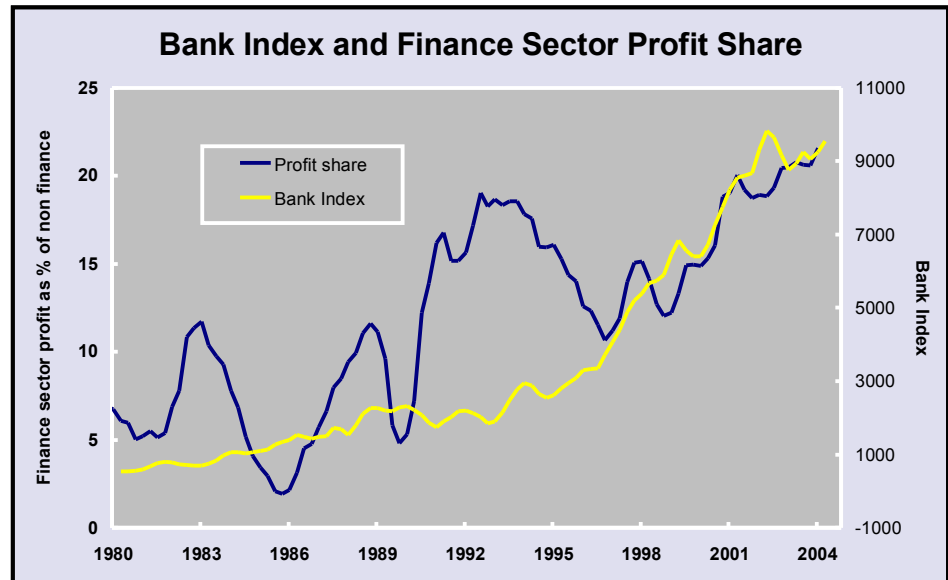
1. PAT + interest paid – tax saving from interest paid at 30% rate

2. Debt + book equity

3. NOPAT as % of funds employed

4. Weighted cost of funds based on current debt/equity structure, debt servicing charges and risk free rate of return + risk premium

THE WEEKLY CHART SPOT



Source: Australian Bureau of Statistics and ASX

The strong gain in Australian finance sector profits relative to economy-wide corporate profits helped drive the performance of banking stocks since 1995. Having re-priced their product offerings and reduced costs aggressively, it is less likely that the banks will be able to outperform their clients.

FINANCIAL REPORTING: WHAT TO LOOK FOR CONT'D

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confronting each new reporting season.

For an investor attempting to discern value, there are essentially three variables on which attention should focus:

- the level of profit from normal business operations;
- the funds employed in generating that profit; and,
- the target rate of return.

Despite these three relatively simple measures being critical to assessing value, companies are not required to report them in this form.

Headline profit numbers, for example, usually contain far more than the operating profit measure needed for analysis. Capital transactions and non-cash impacts on the reported profit will be mixed with the operating numbers we want to isolate.

However, most companies highlight differences between ongoing profitability (through which fundamental value can be driven) and what accounting standards say must be reported. This can usually be found in their presentations and commentaries lodged with the ASX.

One further adjustment is needed to make operating profits more directly comparable across companies. A company with more debt will deliver a lower profit outcome

than one using more equity although the underlying business performance might be essentially the same.

To avoid this distortion, it is usually preferable to take out the effect of gearing. The calculation of NOPAT in the table makes this adjustment.

The next step is to determine whether higher levels of company profitability are being driven by managers with access to more funds and simply buying size or whether the higher profitability reflects astute managerial and business performance.

For this purpose, *thebigpicture* usually uses debt plus book equity as an indicator of funds employed to generate the profit.

This is not entirely satisfactory because companies have some discretion in how they modify asset values. Under accounting rules, once asset write-downs are taken, life can go on as though the funds used to purchase those assets had never existed. There is no obligation on managers to measure their performance against the cost of those written-off funds.

Unfortunately, this is just another example of how the arbiters of accounting standards conspire against the best interests of equity investors.

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FINANCIAL REPORTING: WHAT TO LOOK FOR CONT'D

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Nonetheless, in practice there is little alternative and this measure will normally have to suffice as an initial indicator of the funds employed.

We can now calculate a rate of return. A successful company will have a NOPAT return on funds employed which exceeds the cost of raising and holding both the debt and equity funds which are needed for the business to operate.

The cost of capital, the target rate of return above which the company is adding

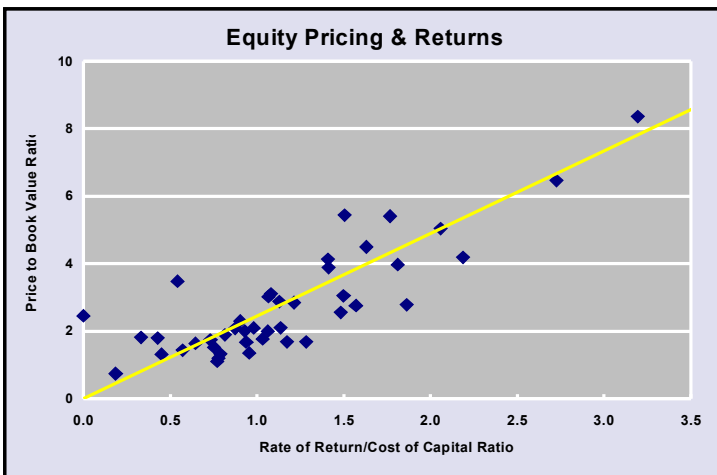
They show Wesfarmers adding value with a return in excess of its cost of capital. Moreover, the gap between its return and its cost of capital widened flagging further potential for share price appreciation.

The same type of calculation can be carried out for any listed company. The chart, based on financial data for the year ended June 2003, summarises how market prices respond to movements in this measure of financial performance. The positive correlation between the variables on the two axes illustrate why it is a useful tool for an investor making judgements about potential stock price performance.

The horizontal axis shows the spread between the return on funds employed and the estimated cost of capital for some forty of the largest industrial companies listed on the Australian stock market.

The vertical axis shows the market capitalisation premium over company book value as one indicator of the extent to which the market rewards companies with superior economic returns measured in this way.

“Whatever one’s approach to assessing company financial performance, the key message here is the importance of having firm guideposts by which to make judgements.”



value for shareholders will be set by market conditions, company credit ratings and the relative importance of debt and equity in its funding mix.

The table on page one provides an example of how this framework might have worked for the 2004 Wesfarmers result reported last week.

In this instance, we cut through the press flummery about “Saint” Michael Chaney and find the four ingredients to carry out the calculations illustrated in the table (or ask our adviser to do it).

Whatever one’s approach to assessing company financial performance, the key message here is the importance of having firm guideposts by which to make judgements.

Knowing what to look for will greatly assist an investor in sidestepping the reporting season information avalanche.

CONTINUOUS DISCLOSURE FOR GOVERNMENT, TOO CONT'D

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ness in the land.

One amendment to the charter could be contemplated to align the two more closely. Require the Treasury and Finance departments to report every three months in the 12 months leading to the end of a Parliamentary term on whether there has been any material change to the financial position of the government.

If the politicians say this is too hard, they

can be told to contemplate the continuous disclosure regime they insist on applying to companies.

If a Prime Minister decides to exercise his discretion to call an election more than 12 months before his term is due to expire, he should only be able to do so if he releases at the same time the economic and fiscal outlook report. But, you will say, its preparation will leak signalling an election is on the cards. Sure, but you either believe in transparency or you don't.

CONTINUOUS DISCLOSURE FOR GOVERNMENT, TOO

Anyone with an interest in good policy should be concerned at the disclosure rules which apply to the government as we approach a federal election. There might be some lessons to be drawn from the continuous disclosure regime applying to corporates.

Ideally, an election campaign should be a battleground for all the best policy ideas that the nation can muster. There should be ample time for them to be debated and for people to make judgements about which would work best.

Unfortunately, we hear too often that "we cannot say what we are going to do until we see the government's financial position".

Taxation policy is the standout example. Debate on this critically important area is entirely stifled by this argument.

To be sure, this is partly tactical. Remaining a small target until a last minute dash for the electoral line is an often-used ploy. However, there is another important constraint on full policy discussion.

Under the so-called charter of budget honesty enacted in 1998, the Commonwealth Treasury and the Department of Finance are required to release an economic and fiscal outlook report within 10 days of writs being issued for a general election.

The charter also includes rules about the release of fiscal information at other times in the political cycle. Among its stated aims is to make sure that the public is kept better informed about public finances and that there is transparency in fiscal policy.

In that sense, the charter is comparable to the governance rules which apply within corporate Australia.

Bear in mind, however, that the duration of an election campaign from the issue of writs to voting might be as little as 33 days. This means that the government's disclosure obligation can be inoperative until 23 days before people are due to vote and probably within one week of the individual parties having to launch their formal policy statements.

This is not conducive to soundly developed ideas on which to base a pitch for national government.

This delayed disclosure regime (in contrast to continuous disclosure) is a considerable advantage to the incumbent party whose ministers can be briefed every day by officials about fiscal conditions and who are able to ask any questions they like about the outlook until the election is called.

They have no obligation to disclose what they discover. In fact, they can use the prospective release of the statement as a screen to hide even more than they might usually feel comfortable concealing. The prescribed timing of the outlook report can stall the beginning of effective policy debate.

This is in marked contrast to how the government thinks disclosure should work in the listed company environment.

John Howard, the CEO of Australia Limited, could not wait until after he had called an AGM to fulfil his disclosure obligations. Nor could he decide not to obtain an updated assessment of business conditions from the CFO to avoid having to say anything.

Under continuous disclosure, there would be an implied obligation on CEO Howard every day to affirm that there was no change to the previously announced financial situation which would be relevant to the reasonable person deciding how to cast a vote.

Moreover, the onus would be on the CEO to have processes in place to ensure that any material change would be drawn to his attention and would be communicated promptly to Australia Limited shareholders (and the alternative slate of directors standing at the upcoming AGM).

And all of this would be wrapped in some meaningful criminal sanctions.

If continuous disclosure is now regarded as an essential underpinning for conduct in corporate Australia, there must be some logical extension to the biggest busi-

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