

# thebigpicture

guideposts for the private investor

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## **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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## ACCOUNTING STANDARDS: BENEFITS QUESTIONED

Companies are presently channelling more resources into their accounting functions to make their public reporting conform to international accounting standards. This is to make them more attractive to offshore investors. However, investors want more than a change in accounting practices.

For reporting periods beginning after 1 January 2005, Australian companies are to report their financial results in line with international accounting standards. They will also have to report prior year comparatives on the same basis so that they should be converting their systems to accommodate the changes already.

The changes can be time consuming and costly. However, there are supposed to be benefits. Underlying the move to common accounting standards is the idea that Australian companies will find it easier attracting investors in international equity markets.

Greater conformity with foreign accounting practices should reduce information processing costs for potential investors and enhance the credibility of the accounts when they are published. In short, Australian companies should benefit from lower costs of capital.

A paper<sup>1</sup> by Mark Bradshaw, Brian Bushee and Gregory Miller (BBM) throws some light on how US investors might react to a switch in accounting policy by Australian companies. It examines the relationship between choice of accounting method and level of investment by US institutional investors in non-US firms.

The attitude of US investors is critical to a judgement about the value of making the move since North America is where Australian companies most often seek to tap funds.

BBM find that firms with higher degrees of conformity to US accounting standards do exhibit greater levels of US institutional ownership. However, the study also finds that a reduction in adherence to US accounting standards does not reduce the extent of US institutional ownership. In other words, once investors become familiar with a company as an investment they are more likely to maintain an exposure to it.

Accounting standards, of themselves, are not critical to keeping US investors on the register. BBM's conclusion is that accounting policy choice has greater impact once attention has been drawn to the firm through some other mechanism. As a first step it lacks impact.

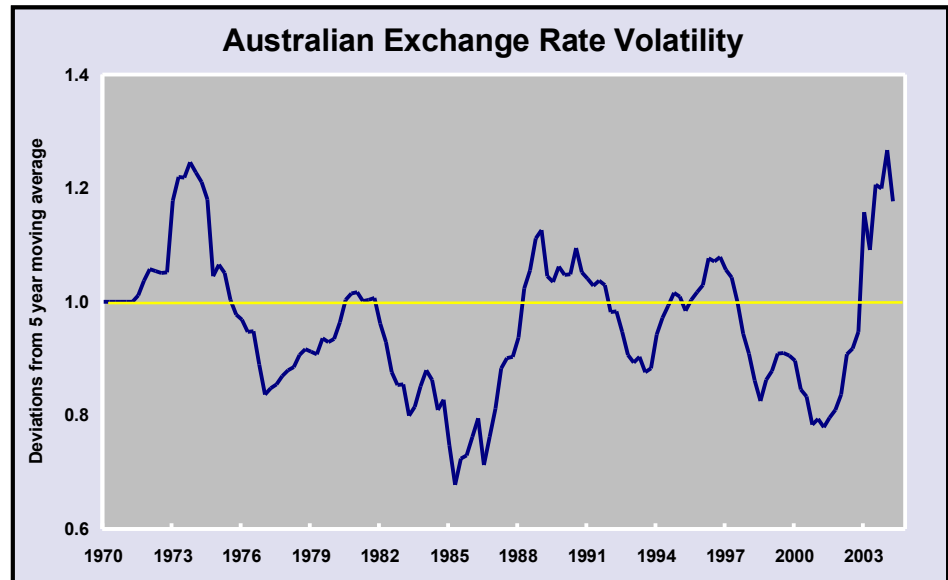
BBM's conclusion is consistent with other research findings that greater visibility significantly improves the chance of attracting investors. Visibility indicators might include being part of a stock market index, having an analyst following, firm size, a recognisable brand name or having an ADR listing on an American exchange.

There is also research support and considerable empirical evidence that marketing direct to US-based fund managers over a sufficiently long period of time for them to gain familiarity with an investment story is necessary to complement these other visibility boosting efforts.

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## THE WEEKLY CHART SPOT



Source: Reserve Bank of Australia and *thebigpicture* Economics

As they are reporting their annual results, companies have been lamenting the impact of the exchange rate on their Australian dollar results. The chart shows deviations from five year moving averages against the US dollar as an indicator of deviations from embedded expectations.

The rapidity of the most recent upturn has been unusual but there were few comments in the prior four years that the exchange rate was supporting abnormally high profits which had not been anticipated. Then, it was good management worthy of a larger bonus cheque.

## ACCOUNTING STANDARDS: BENEFITS QUESTIONED CONT'D

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This is consistent with the experience of Australian companies which have garnered significant quantities of offshore equity investment, arguably more than their fair share. Overseas holdings amounting to 30% would be commonplace among larger Australian listed companies. Higher levels would not be unusual.

There are several reasons why Australian companies have been unusually successful in capturing investment funds.

- The Australian market had long been known for its resource companies and the global commodity market exposure which few other equity markets were able to offer.
- Australian equity brokers set up branches in London and New York some 25 years ago to promote investment in a broader range of Australian companies, successfully raising Australia's profile among the growing number of international fund managers in these locations.
- During the 1980s, Australian investment opportunities were promoted vigorously by Australia's corporate entrepreneurs, a phenomenon with some longer term costs but one which helped raise the profile of the Australian market with specialist Australian managers becoming a feature of the early global funds management industry in the USA.

- Many offshore fund managers felt comfortable with the language and institutional arrangements in the Australian market whereas many of the markets with which Australia competed were politically unstable, personally uncomfortable and had poorly developed regulatory systems.
- Australian company executives regularly market themselves among offshore institutions to sustain the competitive edge.

Complaints about being disadvantaged have been loudest among smaller Australian companies especially some of the earlier stage technology-oriented stocks. They view covetously the higher market capitalisations of many comparable companies offshore and wonder why they too cannot be accorded such earnings (or revenue) multiples.

Unfortunately, for many of these Australian companies access to capital is limited by their reputation for performance, as a group, not standing up to scrutiny. Perceptions of risk and failure to perform against foreshadowed targets have disadvantaged them.

More broadly, foreign investors in the Australian market have been disadvantaged by a long-term decline in the value of the Australian dollar. A disproportionate num-

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1. Mark T Bradshaw, Brian J Bushee and Gregory S Miller, Accounting Choice, Home Bias and US Investment in Non-US Firms, Working Paper.

## COMMODITY PRICE STRATEGIES

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velopments elsewhere to restore the market balance. Usually, when users of raw materials have been hurt by shortages, they will encourage more than enough additional production to rebalance the market and emphatically change the balance of negotiating power.

As Chip Goodyear, the BHP chief executive officer, observed at the briefing, if this happens markets will go very quickly from shortage to such large-scale oversupply that it could take 20 years of demand growth to make up the difference. He might have been exaggerating a little, but that is the clear lesson from history BHP wishes to avoid.

In short, if BHP does not move to take advantage of higher demand others will. Its choice in the longer term is higher volume with lower prices, current volume with lower prices or lower volume with lower prices.

BHP's optimal course is to lock in customers to help underwrite expansions. By working in a co-ordinated fashion with customers, it would be aiming to scare off others looking to take advantage of temporary shortages to gain market share.

Historically, this has never worked. Put simply, all resource companies look at the same set of indicators and react in the same way at the same time. Meanwhile, users become more risk averse and encourage more supplies than they will be

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able to use in the immediate future.

Might this cycle be different? One should always hesitate before forecasting a change in human nature. However, a decade of mergers and resources industry consolidation might make a difference.

There are now fewer large resource companies participating in the global market. Those remaining are also larger than their predecessors and account for bigger shares of the markets in which they operate.

This change in the economic power balance might mean suppliers are better able to reassure customers of their ability to meet demand and prevent customers from encouraging alternative production sources.

This is BHP's hope. Either way, prices will be under pressure. BHP is flagging that it has no interest in keeping them aloft at the expense of the longer term accretion in company value.

For an investor (and there is a distinction here between an investor and a speculator on commodity price movements), the prospective output profile of any resource company becomes more important from this point in the cycle than what might be happening to commodity prices.

Companies with well-defined output strategies based on commitments from end-users should be more attractive to investors than those simply reliant on the benefits of price movements.

*"...there is a reaction continuum which begins the moment prices rise and ceases only when prices fall and pessimism returns. However much BHP might prefer to live off the benefits of higher prices, it knows that its future prosperity cannot rely on them."*

## ACCOUNTING STANDARDS: BENEFITS QUESTIONED CONT'D

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ber of listed Australian companies have also failed to survive their own strategic mismanagement or been permanently scarred by it.

Australia's success has been despite these failings none of which could have been compensated for by different accounting policies.

Aside from confirming that more than accounting policy changes are required to enhance international investment market positioning, the BBM analysis also suggests that US institutional investors prefer US standards over any other.

This weakens the argument in favour of a switch to international standards unless

the US is set to do likewise.

Among standard setters in the USA, there has been notional acceptance that convergence between US and international standards should occur.

However, US authorities are not making an absolute commitment, according to the US Financial Accounting Standards Board (FASB), because of "the volume of differences and the complex nature of some issues" so that "the FASB anticipates that many differences between US and international standards will persist well beyond 2005".

Against this background, a payback for the hard work in changing standards in Australia may be quite some time in coming.

## COMMODITY PRICE STRATEGIES

**BHP Billiton (BHP) has made it clear that, in acting to maximise its own value, it is likely to put downward pressure on commodity prices.**

In commenting on the price outlook for the commodities it sells, Marius Kloppers, BHP's Chief Commercial Officer, has observed that there was enough prospective brownfield capacity to meet the additional raw material demand which was foreseeable. This was despite the apparent strength of global raw material demand and the buoyancy of prices at present.

He made his comments in a briefing for investment analysts following the release of the company's annual results.

BHP is in a good position to make this judgement since it accounts for a significant part of the additional capacity which might become available across a broad range of mineral commodities.

BHP has also foreshadowed that its own supply decisions will be tactically tied to an assessment of what is in its best interests for the longer term. Supply expansions will proceed if they are "npv accretive".

While Kloppers' comment was a general one with varying degrees of applicability to the diverse range of mineral commodity markets in which the company operates, it was a significant statement of how one of the most influential participants in these markets was going to conduct itself.

There is little doubt that continuing high prices would be preferable for BHP and its peers in the international minerals industry. In 2004, BHP's EBIT rose from US \$3,481 million to US\$5,488 million of which US\$3,145 million (i.e. more than the total profit movement) was attributable to commodity price gains. If sustained, this increment in income could be worth an additional US\$20 billion to the value of the company.

However, higher prices inevitably attract new production.

- Previously marginal producers which had cut back output might be tempted to restore capacity.

- Miners who might have left behind uneconomic ore when prices were lower could go back to extract it.
- Existing producers might be tempted to accelerate production increases which had been on the planning board for the longer term.
- Smelters and refineries might extend their production runs with maintenance tasks being postponed to take advantage of higher prices.
- Incremental capacity can be added to existing plant by taking out bottlenecks.
- New deposits can be explored and new reserves delineated adjacent to existing mining operations which can be taken advantage of relatively quickly.
- Small companies might be prepared to fund old mine workings for the short term to obtain a quick cash return.
- Greenfield operations can be promoted more easily.
- Within some secondary markets, scrap recoveries will be spurred by higher prices providing a supplement to primary metal supplies.

The number of different ways in which the market can adjust to higher prices is quite extensive. Some can have an impact in the short term while others take longer and, in the extreme, might require several years of advance work. However, there is a reaction continuum which begins the moment prices rise and ceases only when prices fall and pessimism returns.

However much BHP might prefer to live off the benefits of higher prices, it knows that its future prosperity cannot rely on them.

- Any signal that it will not be responding to rising demand opens a window of opportunity for others. They are likely to move in an uncoordinated fashion and, in doing so, bring on more capacity than the market might actually need.
- The longer BHP, as an industry leader, delays a supply response, the more likely its customers are to support de-

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