

# thebigpicture

guideposts for the private investor

Week Commencing 31 May 2004

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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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## CEOs FACING THE PRESSURE

One of the challenges faced by Australian executives is how to respond to the constant demands for newsworthy business decisions. The pressures might be pushing companies toward poor strategic outcomes.

Michael Chaney, the Wesfarmers CEO sometimes dubbed Australia's most successful business leader, was reported recently as saying that "the pressure exerted on chief executives by journalists seeking growth stories is unrelenting".

As leader of a management team which prides itself on the rigour of its approach to investment decision making, Chaney was lamenting how little commentators valued such standards when urging strategic decisions upon companies. They were more interested in having something to report than in giving companies time to take considered and financially sensible decisions.

There has long been a tendency in Australia for executives to be overly concerned about 'what the market thinks' rather than setting the performance standards themselves. That this is something having an impact on someone of Chaney's stature should be a concern. No wonder lesser mortals succumb to the pressures.

The Australian community of CEOs, financial analysts and business reporters is a very small one. This affects how CEOs are treated, the pressures on them and how they respond.

CEOs of some of the most prominent companies become household names in ways few executives would become known outside Australia. Not only are their strategic decisions reported in the financial press but their salaries, who they were dining with, their house renovation plans and their holiday arrangements might all be public information. Barely an edition of the daily financial press goes by without one such reference.

The more private aspects of their lives might also be reported in the USA or the UK but in the National Enquirer not the equivalent of the country's leading financial newspaper.

An Australian CEO assumes slightly larger than life characteristics. One of the consequences is that speculations about strategy become very personalized. Business changes are frequently described in terms of the CEO's personal ambitions and life cycle rather than in terms of corporate strategy and business development. An executive who has not made an acquisition is 'getting tired' or 'running out of ideas'. Others looking to make changes are 'preparing their legacy'.

It takes a hard man to ignore the daily personality commentary particularly when it evolves into suggestions that the absence of major transactions is symptomatic of failure.

If the average duration of a CEO's tenure is about four years, it is conceivable that he should be able to run the business without any significant strategic initiative during this period.

However, public commentaries start on his appointment about how long he is likely to have in the job. Benchmarks about what he has to do and how swiftly he must act to be able to ensure his tenure emerge quickly.

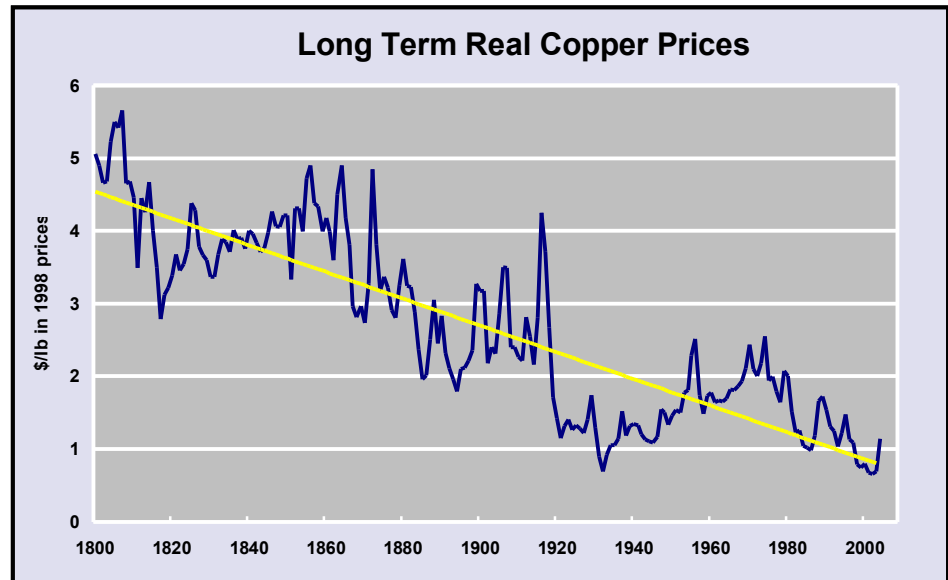
*"... the highest market price premiums are reserved for those companies with the best returns... [not] large companies or faster growing companies."*

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## THE WEEKLY CHART SPOT

Copper prices have risen by 70% over the past 12 months.

The rise does not change the basic predicament for resource companies: a long-term downtrend in real commodity prices (probably accompanied by an uptrend in real mine operating costs as reserves are depleted).



Source: International Monetary Fund, World Bank, commodity exchanges & *thebigpicture* Economics

## RUSSIA: A GIANT STIRRING CONT'D

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several larger US states, including California, and the energy lobby have all seemed to become less hostile in recent months.

Whether or not Kyoto is in Russia's best interests, it needs to redesign its economy. While its economic growth rate has averaged a creditable 5.7% over the past three years, the performance has been too dependent on higher commodity prices.

Looking ahead, Russia is one of the countries likely to be most affected by lower fertility rates and the slowdown in population growth which is evident across all the more developed nations.

According to the United Nations global population research programme, Russia's population is expected to fall from 145.6 million people in 2000 to 129.0 million in 2020 and 101.5 million in 2050.

While all developed countries will face the impact of lower fertility to varying degrees, the impact on Russia will be among the most severe. By comparison, the US population is expected to increase by 123.7 million over the fifty years between 2000 and 2050. While the 0.7% a year growth

rate is weaker than the 1.2% growth rate over the prior fifty years, it offers a stronger base for domestic economic activity than the underlying trend in Russia.

The Russian president has targeted a doubling in GDP over the next 10 years. For Russia to achieve this target, it must improve the productivity of its industry and exploit its raw materials resource base more efficiently. To do that it will need to shed the remnants of its communist past and improve product quality, admit foreign capital and offer greater investment security.

All of this implies a considerable reform agenda. However, President Putin seems determined to push ahead. Perhaps more importantly, he also seems to have few domestic political rivals (notwithstanding the attempts of Chechen separatists to destabilise his regime) to prevent his agenda being implemented. One indicator of this is the turnaround in his position on Kyoto. It appears that he will be able to extract a favourable ratification vote from the Russian parliament more or less on request.

## CEOS FACING THE PRESSURE CONT'D

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recorded more value than large companies or faster growing companies.

Returns in this sense can be garnered just

as well, if not more readily, from operational improvement and efficient capital management as from flashy business acquisitions or innovative funding structures.

## CEOs FACING THE PRESSURE CONT'D

(Continued from page 1)

A complete focus on operational improvement is unheard of. Perhaps John Stewart, the newly appointed CEO of National Australia Bank, will be able to concentrate on operational improvements and could spend his tenure without having to justify the absence of a significant transaction. However, this is only because his predecessors had succumbed so fully to the pressures to be strategically active.

Intertwined with this small community phenomenon is the Australian propensity for corporate overstretch. The Australian corporate landscape is littered with companies which have gone one step beyond their competence, causing permanent shareholder losses.

There are egregiously catastrophic examples like an HIH but there are also those that survived, wounded. Examples include National Australia Bank, Southcorp, Burns Philp, Amcor, CSR, Aristocrat Leisure, Pacific Dunlop, ANZ, Westpac, Western Mining, AXA, Brambles, BHP, Coles Myer, CSR, Foster's.... The list goes on. Companies are conspicuous by not being on it.

National Australia Bank used to be highly regarded for having escaped the strategic misadventures in the late 1980s that afflicted some of the other banks. However, it seems that it is only a matter of time for a major Australian company to be added to the list.

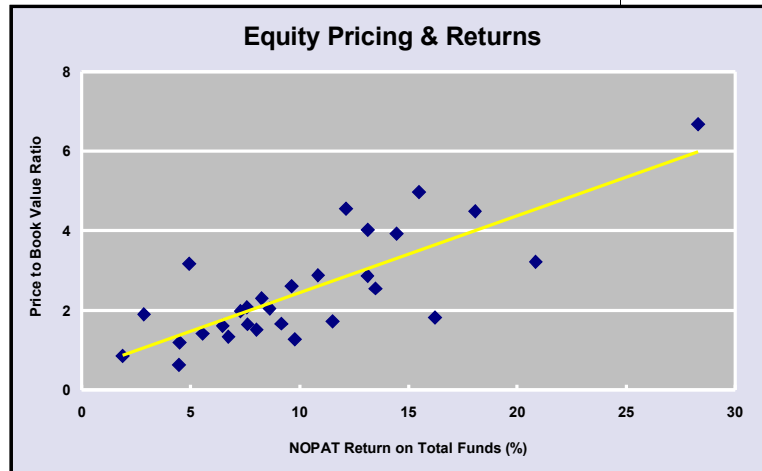
Strategic overstretch subsequently requires a lengthy period of redirection as new management has to craft something better from the broken pieces by patching up the core business and defining a new strategy.

Not only is value lost in the initial mistakes but opportunities are foregone during the rehabilitation further eroding shareholder value.

Overlaid on this are the continuing efforts of Australia's investment banks. Their executives are paid according to whether they persuade Australian companies to undertake a large transaction. Whether it adds genuine economic value is not a primary consideration for them. Nor should it be their responsibility, as service providers, they might rightly argue.

In any event, the investment banks are yet another group buying for a CEO 'to do something'. The constituency for no action is nowhere to be seen.

The small Australian market might also be



a source of additional pressure. It forces Australian companies to consider offshore growth options even when they might not have the necessary management depth to handle the associated challenges.

Another force might be the conservative political persuasion of many business leaders and their advisers. Politically motivated advice has frequently led companies to supposedly more business friendly offshore markets.

So the forces on the CEO 'to do something' are considerable and little wonder that few can withstand the pressures.

The irony, of course, is that there are few rewards for getting it right. An acquisition will very frequently result in a valuation downgrade since investors know that they are risky and that the track record is appalling.

The same commentators who goaded executives to act will readily turn on them to point out the risk they have created in going for growth by buying assets.

More importantly, at the end of the day, the empirical evidence says that size does not matter. The market rewards improving returns on the funds employed in businesses.

As the accompanying chart shows, the highest market price premiums are reserved for those companies with the best returns. Well managed companies are ac-

*"It takes a hard man to ignore the daily personality commentary particularly when it evolves into suggestions that the absence of major transactions is symptomatic of failure."*

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## RUSSIA: A GIANT STIRRING

Since the collapse of communism, Russia has become the forgotten giant. There were signs in the past week that President Putin was prepared to deal his way back to a position of greater influence.

News services reported last week that EU Trade Commissioner Pascal Lamy and Russian Trade Minister German Gref had agreed to a negotiating framework under which:

- Russia would ratify the Kyoto climate change protocol; and,
- the EU would support Russian efforts to join the World Trade Organization (WTO).

That Russia would be prepared to support the Kyoto treaty was a surprise. Studies commissioned by President Vladimir Putin had concluded that Russia's best interests might not be served by signing up to Kyoto, the treaty negotiated in December 1997 aimed at reducing emissions of carbon dioxide and other greenhouse gases.

Russia's support could make the difference between the protocol being implemented or failing. To come into effect, it needs the support of developed nations responsible for 55% of the greenhouse emissions targeted for reduction.

Since US President George Bush has opposed ratification of the treaty by the USA, Russia is the only country big enough to carry the world over the threshold.

At the same time, Russia is the last major economy still outside the WTO. Membership of the WTO would ensure that Russia can get access to other countries' markets on at least equivalent terms to third nations.

President Putin would also be thinking that integrating the Russian economy with the rest of the world would facilitate its restructuring by making it more open and better able to adapt to international competitive pressures.

Being admitted to the WTO will also confer additional legitimacy and provide security

for potential investors.

Membership is, however, accorded by consensus so that, in Russia's case, it must ensure that there is no major nation that has grounds for objecting to any of its trade practices. One of the stumbling blocks had been EU objections that subsidisation of domestic gas prices by the Russian gas monopoly, Gazprom, was unfair.

The Europeans have been concerned that Russian gas users pay only one fifth the price non-Russian gas users are charged by Gazprom. Apparently, the Russians have indicated that they will move progressively to raise domestic gas prices so that Russian users are not given an advantage in their trading efforts.

Nonetheless, Russia will have to negotiate specific arrangements with the USA, China and Japan, at least, before it will be able to lay a claim for a successful membership bid. The US negotiators will be particularly concerned about access to investment opportunities on an equal basis and recognition of intellectual property

*"The Russian president has targeted a doubling in GDP over the next 10 years. For Russia to achieve this target, it must improve the productivity of its industry and exploit its raw materials resource base more efficiently."*



rights since Russia is the largest manufacturer of pirated US videos and music CDs.

The apparent willingness of Russia to deal on Kyoto will pressure the US to adopt the Kyoto standard as well. There are already signs on the domestic front that opposition to Kyoto is melting. The US Senate,

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