

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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A BASKET CASE OR JUST TYPICAL?

Is National Australia Bank just a typical Australian company or a basket case - or both? The question is prompted by the bank's diagnosis of its ailments at its annual meeting last week.

John Stewart told shareholders at the National Australia Bank annual meeting that the problems he discovered when he took over at the bank were worse than he had expected.

His appointment almost a year ago was precipitated by the discovery of unauthorised foreign exchange dealings. That alone would not have been enough to force the removal of his predecessor. However, a history of corporate mishaps had been creating anguish among shareholders and, perhaps more than that, there was a history of mis-handled communications which had tried the patience of investors.

Nonetheless, the bank had a strong domestic franchise and most of its problems seemed to come from its overseas investments and not the domestic market. Its general financial performance seemed at least as good as the other major banks.

From this perspective, the company had become accident prone but there was no threat to its viability.

From John Stewart's perspective, however, the events were actually symptomatic of more deep-seated problems that did threaten the bank. There were three he identified.

Risk Aversion

The bank had become too risk averse after the New York terrorist attacks in September 2001 to the point that it had turned away business it should have accepted. There were also too many layers of managers required to approve relatively simple transactions causing it to lose business to more nimble competitors.

Companies did become more risk averse after the New York terrorist attacks. Comments, for example, by Alan Greenspan, based on analysis by Federal Reserve economists, have referred to companies adopting more conservative lending and spending standards after September 2001. One indicator has been a slump in business capital spending relative to cash flows in the USA, illustrated on page two. The National is not alone here.

However, risk aversion is in the eye of the beholder. There were other times when the National's relatively conservative business approach meant it was an example of how to survive. When Westpac, for example, was teetering on the commercial edge fifteen years ago, the National's more conservative approach was being lauded.

Economic Value Added

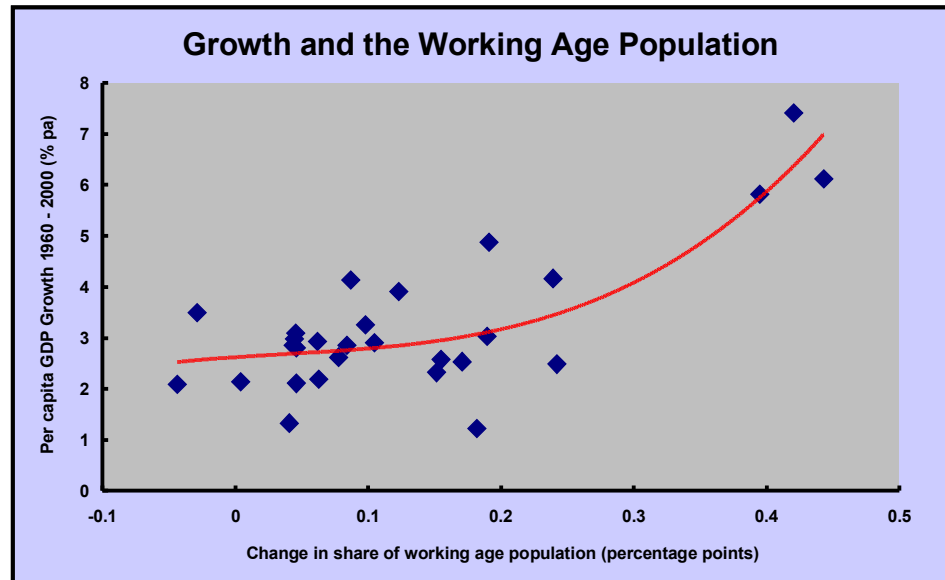
According to Stewart, the bank's bonus system was based on measures of economic value added which caused employees to act contrary to the bank's best interests. In any event, the measures were too hard to understand.

All listed companies have been searching for the right way to reward employees as they balance short term growth with appropriate financial returns. Use of economic value added measures have become increasingly popular.

"...Australian companies were especially prone to strategic misadventure in a way that US and European based companies were not."

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THE WEEKLY CHART SPOT



Source: International Monetary Fund

Demographic momentum has had an impact on economic performance. The chart shows that, among 28 advanced economies, increases in the proportion of working age populations have been associated with higher rates of per capita growth.

The relationship operates through several links. A larger labour force supports higher output and productivity outcomes are improved through enlarged domestic markets. The higher savings levels which go with larger working populations (and lower dependency ratios) also enable more investment spending and stronger financial systems.

The chart data are averages for the period from 1960 to 2000. ■

“Few sizeable Australian companies have been successful at their first attempt in building offshore activities. Generally, they have to move through more than one cycle before bedding down an acquisition....”

A BASKET CASE OR JUST TYPICAL? CONT'D

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three categories, more than half had experienced significant reversals in fortunes, many far worse than anything suffered by the National Australia Bank.

This characterisation understates the incidence of battle scarring. The fall for many has been so severe that they no longer exist. Many others languish outside the top 100 after having held more exalted positions.

Reviewing the list almost 2½ years later adds to the argument. Aristocrat Leisure and Leighton had yet to be scarred when the list was compiled but are now.

thebigpicture concluded that Australian companies were especially prone to strategic misadventure in a way that US and European based companies were not. In part, this was because the small Australian market forces a disproportionate number of Australian companies to look offshore for expansion. The geographic separation of management from their new markets magnifies the usual risks following any

business acquisition.

Few sizeable Australian companies have been successful at their first attempt in building offshore activities. Generally, they have to move through more than one cycle before bedding down an acquisition and having it deliver the rates of return which might have been targeted. Sometimes they need to quit and start again.

In this respect, the National Australia Bank is hardly any different from other Australian companies or other Australian banks (with the possible exception of the Commonwealth which has not been independent long enough to demonstrate its overseas investment skills although, domestically, with its wealth management investments, the same tendencies are being displayed).

So, John Stewart might have been overly critical of his bank. Its problems might not be peculiar and, unless he had spent some time studying Australian business he might be missing this bigger picture. ■

A BASKET CASE OR JUST TYPICAL? CONT'D

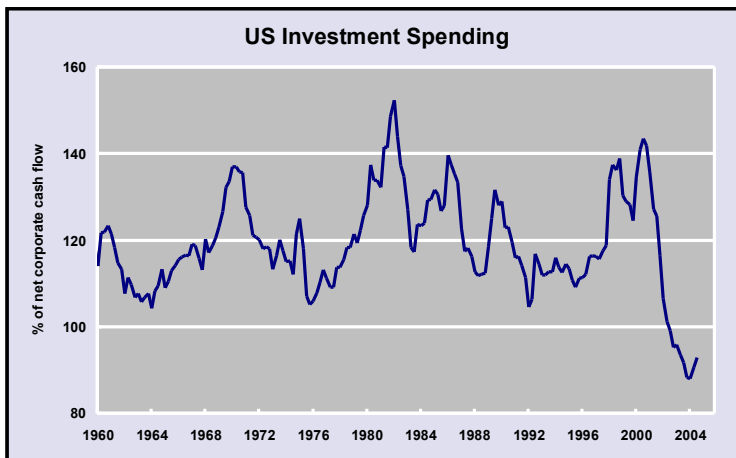
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Economic value added is simply a measure of business performance which takes account of the cost of all forms of capital employed in the business. It implies that any business or investment should return more than the cost of funds employed to acquire or run it.

Suggesting that adherence to this tool was contributing to the bank's failings hardly seems convincing.

There is an abundance of empirical evidence to suggest that companies using these and similar tools are likely to be more highly rated by the market than others.

Moreover, the National's failed investments did not deliver adequate returns. Following rate of return benchmarks did not lead the bank into failing investments.



To the extent that employees did not understand the standards, presumably, inadequate internal education processes were at fault rather than an analytical approach which is in use by some of the world's most successful companies.

One interesting sidelight to this is the appointment of Michael Chaney as Chairman designate. He will formally assume the position after he relinquishes his role as chief executive of Wesfarmers later in the year.

Wesfarmers has made its reputation, and successfully delivered outstanding increments in shareholder value, by adhering strictly to investment return methodologies to which the bank is now attributing inappropriate outcomes.

That said, the bank has not abandoned economic value added entirely as a performance measure. According to the

chairman of the bank's remuneration committee, bonuses will be tagged to a combination of economic value added measures and earnings per share in a 30/70 mix. The combined measure, he claimed, would be easier to understand. On this issue, the leaders of the National Australia Bank appear to be thoroughly confused.

Joining the Battle Scarred

The third failing was too many incentives encouraging the pursuit of growth through acquisitions.

Suffering from investments which have fallen short of their anticipated performance makes the National Australia Bank a typical Australian company rather than unusual. Without a background in Australian business, John Stewart might be missing this.

In October 2002, *thebigpicture* reviewed the top 100 Australian listed companies at that time and defined three categories:

1. **The battle scarred:** companies which had undergone a significant strategic redirection or where the market has, at some time, substantially downgraded its estimation of their capabilities.

2. **Mid-life corporates:** companies which had established a favourable

reputation but had not traversed the full corporate life cycle.... as yet.

3. **The newcomers:** companies which had been divested from the battle scarred or privatisations of previously government-owned assets.

Of the largest 100 companies on the Australian exchange at that time:

- 39 were 'battle scarred'
- 13 were mid-life corporates
- 17 were newcomers
- 16 were foreign based companies or companies being acquired by foreign companies (excluded)
- 15 were property or investment groups (excluded)

That is, of the 69 companies in the first

“All listed companies have been searching for the right way to reward employees as they balance short term growth with appropriate financial returns. Use of economic value added measures have become increasingly popular.”

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CAN RESEARCH BE INDEPENDENT?

More listed companies are paying for research about themselves. That means it is not 'independent' but as long as investors refuse to pay, independent research remains a fantasy.

Virtually all company research for investment decision-making purposes is driven by someone trying to sell something.

Stockbrokers have been the main purveyors of company research. The motivation for initiating coverage of a company has been the higher levels of income which would flow from using the research to persuade a client to undertake a transaction.

Generally, if revenue was unlikely, coverage was also unlikely. Hence smaller and relatively illiquid stocks were given less coverage than those with the potential for higher turnover.

Stocks with 'sell' recommendations attached were also unusual. Having far more 'buys' than 'sells' on its own should not be cause for concern because inherently unattractive companies are unlikely to be covered in the first instance. Nonetheless, there has been a marked reluctance to publish negative views.

Analysts generally want to keep on good terms with the people they rely on for information. There are many stories among brokers of irate chief executives threatening withdrawal of contact because analysts had not been sufficiently fulsome in their praise.

Stockbrokers are also prompted to initiate stock coverage when they fancy their chances to raise capital for a company. Sometimes, in the past, an analyst would have shared in the fees and would have featured in the pitch to get the business.

Executives at listed companies would generally not care about independence. In selecting their advisers, a commitment to research would usually be one of the criteria. Research with a positive recommendation would be more highly regarded than neutral or negative views.

Today, securities regulators are trying to put a wall between corporate advisers and company analysts. Analysts are being

told to live off the income from their research and not the fees from corporate transactions.

However, there is no explicit price tag on stockbroker research so it always has to be funded indirectly through some form of transaction to which a fee is attached.

Clients, too, have got used to research being unpriced making a change of culture very hard to effect.

More specialist research houses whose incomes do not depend directly on associated transactions are being established in the USA and Australia. However, many of these are funded directly by companies paying for research as the latter seek to boost their profiles in investment markets.

Biotech company executives especially like the idea of research houses ignoring the relative sectoral risk and creating additional demand for stock by highlighting the valuation upside in the event that their new products are commercialised successfully.

If a company funded research report happens to be unfavourable, it will probably not see the light of day. Funding for research is likely to continue only if the research is seen to generate additional investor interest.

This is little different from broking firms offering coverage to build corporate relationships. The temptation to subvert research for higher income is much the same. If it exists in one environment, it is hard to imagine it being absent in the other.

When research is initiated in this way, investors cannot assume a company with a research report is a better investment prospect than one without research.

For an investor, the same trap looms. When his need is greatest, he is most unlikely to get what he needs: high quality research from a reputable analyst whose loyalty is not divided.

The only way to avoid the predicament is for investors to pay directly for advice and, in doing so, reward quality and punish poor analysis. ■

"...investors cannot assume a company with a research report is a better investment prospect than one without research."