

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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BUSINESS STRATEGY: SELLING AS A LAST RESORT

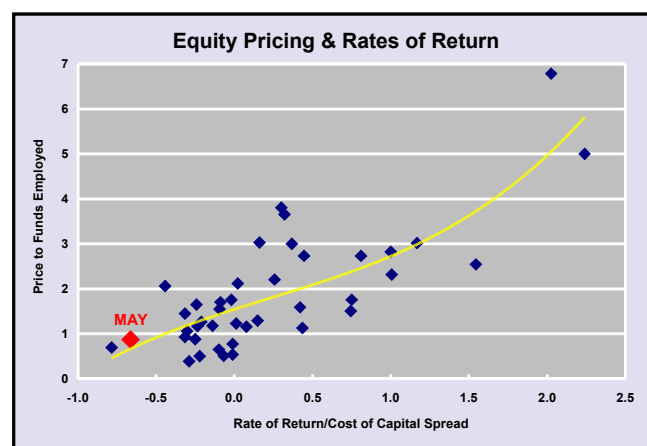
Selling assets is often portrayed as a shareholder friendly act to improve investment returns. The bigger picture might be one of management and strategic failure.

Over the past three completed financial years, the average rate of return on funds employed within the listed health care products company, Mayne Group, has been 3.9% compared with a 10.6% return among *thebigpicture* sample of 55 of Australia's largest listed industrial companies. A long history of financial underperformance has finally forced the directors to consider dismantling the company in a last ditch effort to get more value for shareholders.

Mayne Group is the latest high profile Australian listed company to split itself to become more attractive to investors. As usual, this is the culmination of many failed attempts to get the best from the assets which shareholders have bought. Mayne had been a logistics group with a global franchise before incubating the second domestic telephone carrier and metamorphosing into a health care and junior pharmaceuticals manufacturer and distributor.

It follows a path well-trodden by other companies such as Pacific Dunlop and Southcorp which had failed to deliver the advertised value from their conglomerate structures. In these cases also, there were attempts to restructure the businesses radically. Pacific Dunlop went from a tyre manufacturer, lead smelter and branded clothing company to a condom and rubber glove maker as it sought a meaningful role as a manager of shareholder funds. Similarly, Southcorp moved from being a regional beer producer, water heater manufacturer and packaging supplier to global premium wine marketer. Both ended tragically for shareholders and managers.

“If managers have never been able to get an adequate return... investors should ask what has changed so radically...”



In both cases, company dismemberment was supposed to be a way out of a strategic impasse. In theory, separating the operating parts makes each part easier to understand so that previously suppressed value will become more evident and reflected in market prices.

As well as these two failed examples, WMC Resources and Alumina came out of Western Mining before the former was taken over by

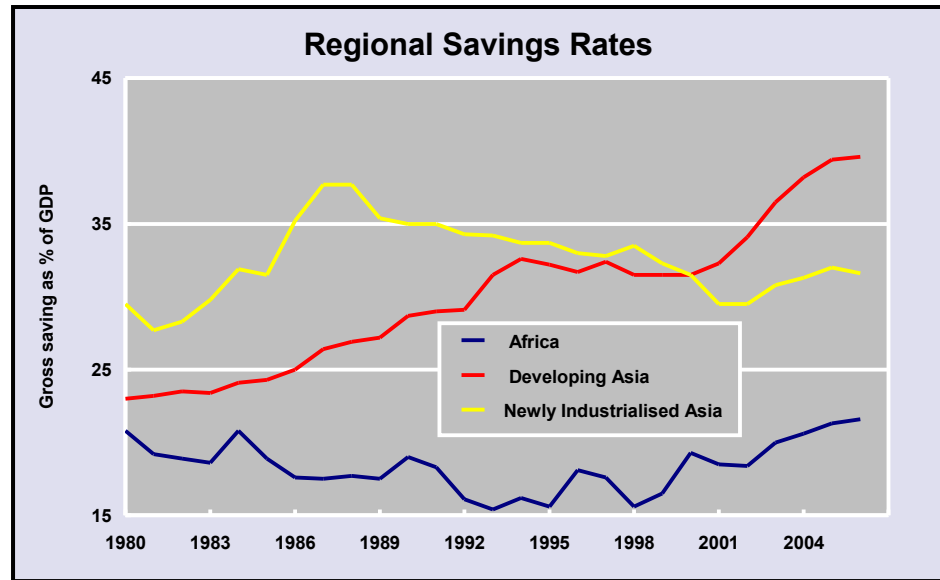
BHP-Billiton. Paperlinx was disorged from Amcor but both languished since the split clarified their shortcomings more than any additional value.

In recent years, the split of CSR has been followed by share price appreciations of 176% and 73% for Rinker and CSR, respectively. However, that followed a long trip in

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THE WEEKLY CHART SPOT

One of the lessons from Asia has been the importance of adequate savings to fund economic development. Within developing Asia, high savings are both the consequence of development and a facilitator. They make Asia less dependent on outside funding. The widening gap between Asian and African savings rates will make it harder for the latter to kick-start the development which will have to occur to alleviate the poverty looming as such a large part of its future.



Source: International Monetary Fund, World Economic Outlook

BUSINESS STRATEGY: SELLING AS A LAST RESORT CONT'D

(Continued from page 1)

the wilderness for the sugar, oil and gas, aluminium and building products conglomerate as it sought a way to harness its financial power for the benefit of shareholders. The split of BHP into a natural resources producer and downstream steel producers has been generally regarded as successful but that also followed many years of underperformance with considerable managerial upheaval and poor investment returns.

Even when a final solution has been delivered, the lessons have been mixed. Arguably, the BHP steel assets and CSR's US-based building products assets benefited from their greater independence. However, in both cases, more favourable economic conditions helped considerably.

In the end, asset sales were a last gasp effort for managers who had tried all the alternatives but could not generate consistently competitive returns from the funds they had inherited.

The trap for investors is that they become so attached to the rhetoric surrounding these companies that the history is ignored. Surely, goes the argument, such high profile companies with such well paid managers and advisers must get it right eventually.

There are two issues which investors should clearly differentiate. One is the underlying financial performance of the company. The other is whether or not financial

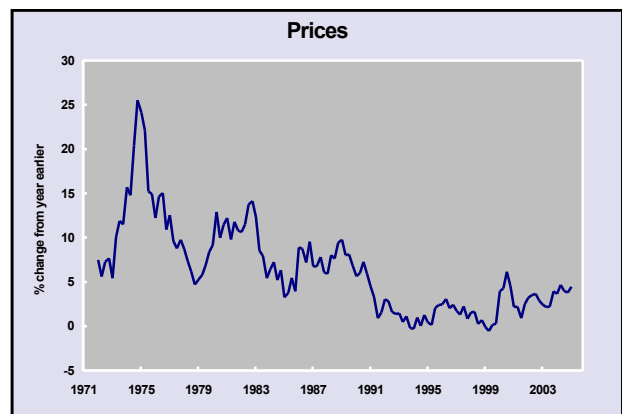
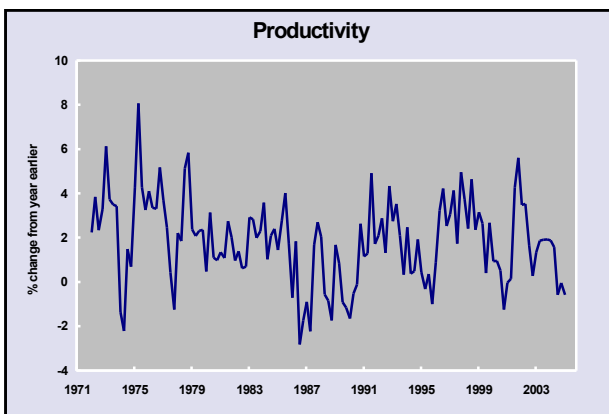
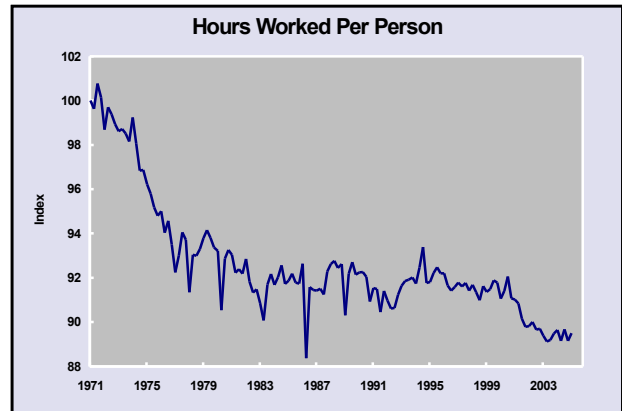
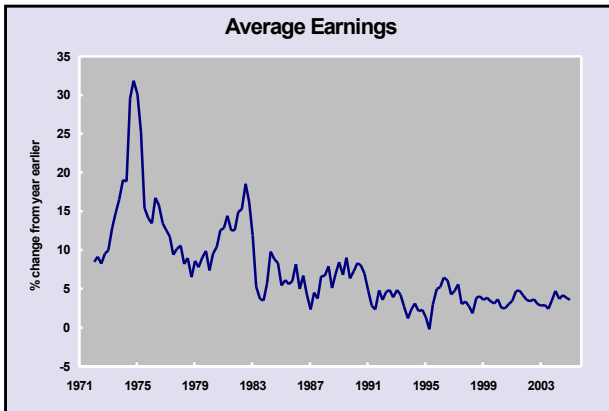
outcomes are properly reflected in share price performance.

If financial performance is adequate but ignored by investors, managers might have a legitimate gripe and there is investment potential. However, if a company has been unable to achieve an adequate financial return, there is little basis for criticism of the market's failure to find hidden value. The market probably does understand only too well.

thebigpicture has frequently referred to how markets give companies with high returns on funds employed a pricing premium and accord the lowest share prices to those companies with the poorest financial performance. The chart on page one depicts rates of return and their relative prices at the end of June for the largest 55 companies followed by *thebigpicture*. Not surprisingly, Mayne Group is one of the companies to the extreme left of the data set.

However tempting it might be to give underperforming companies one more chance, history presents a compelling argument against doing it. If managers have never been able to get an adequate return from assets, investors should ask what has changed so radically that they will now do so much better. There may be reasons (and Mayne Group might be a choice investment now) but the burden of proof should rest firmly on the shoulders of the managers seeking another chance. ■

LABOUR COSTS: PRICES ARE COMPENSATING CONT'D



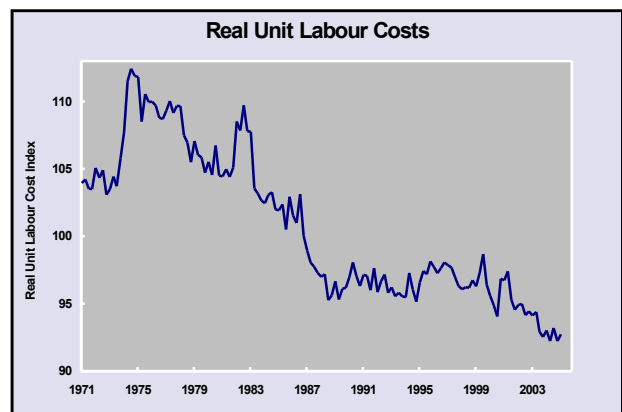
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- price increases which provide a chance for companies to boost their profitability to offset any deterioration in nominal unit labour costs.

This macroeconomic measure is akin to an economy-wide measure of business operating margins. Wages might be rising, pushing up costs with a potentially detrimental effect on profits but offsetting productivity gains from more efficient use of plant, for example, might restore profitability. In more buoyant times, price rises might be relatively easy to get and these will further extend any improvements in profitability.

On a 20 year perspective, real unit labour costs have been falling by 0.5% a year with improving productivity and rising prices offsetting an average 4.4% annual rise in labour earnings.

The picture has changed somewhat in the last year. Continuing growth in average earnings, at less than the average long-term rate of increase, was accompanied by a highly unusual reduction in productivity (adding to unit costs). However, there was a larger than average increase in prices to offset these changes so that business was able to maintain its margin improvement albeit at a more subdued rate than it has been used to showing.



While this is a good outcome insofar as it implies continuing strong profitability, it throws up at least three danger signs.

- Higher prices raise the risk that policy makers will be more inclined to raise interest rates.
- Sustaining higher prices depends on having enough economic power and risks inviting competitor responses.
- Internal cost controls and process improvements are less evident suggesting limits on the capacity to grow profitability without a new commitment to cost improvement. ■

LABOUR COSTS: PRICES ARE COMPENSATING

Improvement in company cost performance has become less noticeable. Prices have become a more important contributor to profitability.

Real unit labour costs are a macroeconomic measure of business performance. They are made up of four elements:

- wages, the basic cost of labour;
- hours worked, measuring the extent to which workers might be reducing or increasing their work input;
- productivity, showing the extent to

which efficiency might be improving to offset the additional costs from higher wages and any reduction in hours worked; and,

Australian Real Unit Labour Costs			
Annual percentage changes			
	Long-term 20 Years	Medium-term 5 Years	Short-term 1 Year
Average earnings	4.4	3.6	3.5
Hours worked	0.1	0.3	0.2
Productivity	(1.3)	(1.2)	0.6
Prices	(3.5)	(3.2)	(4.4)
Total	(0.5)	(0.6)	(0.3)

(Continued on page 3)

“On a 20 year perspective, real unit labour costs have been falling by 0.5% a year with improving productivity and rising prices offsetting an average 4.4% annual rise in average labour earnings.”

CHANEY: HOW CAN THE OTHERS COPE?

The departing chief executive of Wesfarmers has again decried the short term pressures on executive decision-making.

As he departs the senior executive role at Wesfarmers, Michael Chaney, Australia's most successful chief executive, has again referred to the inconsistency between running a company with an eye to the long term and having to respond to the demands of institutional investors.

According to Chaney, sound corporate governance with its eye on the long-term is more consistent with the profile of the typical retail investor than the institutional fund manager.

The former would consider a one-off rise in the share price followed by years of steadily growing (and predictable) dividends an acceptable outcome.

Given a choice about how the identical value could be delivered, the institutional investor, on the other hand, would prefer frequent capital appreciations. Institutional investors, driven by having to report quarterly portfolio values, would be critical of a company whose share price had already risen as far as it would go (whatever

the subsequent dividend flows).

While there are areas of grey between these two extremes, many institutional investors can be forceful and influential in putting their views.

Directors used to be protected from some of these pressures and could act as a countervailing counsel to managers who might have been overly influenced by them. However, in recent times, chairmen have become far more involved in representing their companies to institutional shareholders and are now subjected to the same demands for short-term performance.

Managers also have growing proportions of their incomes and wealth tied to the share prices of their employing companies so that their own interests are often closer to those of the fund managers than the retail investors.

If one of Australia's most successful and financially disciplined managers feels these pressures, how are the lesser mortals coping? That is a worry for the investor looking to implement a 'buy and hold' investment philosophy knowing it is contrary to the interests of the bigger fund managers in the market. ■