

# thebigpicture

guideposts for the private investor

Week Commencing 13 June 2005

## **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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## CORPORATE SUSTAINABILITY GUIDEPOSTS

**An investor needs to judge whether a company can sustain its existing financial performance. That is best done with some simple, consistently applied guideposts.**

A large part of a company's value is embedded in its existing profit. For example, in 2003/04, Coles Myer had an operating profit before interest of \$610.7 million. An estimated cost of capital of 9.9% implies a capitalised value of the existing profit base of about \$6.2 billion or slightly over 50% of the company's total enterprise value.

Because the existing profit base contributes such a large part of the overall value of the enterprise, it is important for an investor to know how sustainable it is likely to be. Its growth prospects, and the balance of the company's value, also depend on the solidity of this base.

Different methodologies are used by management consultants, business strategists and stock analysts to measure a company's competitive strengths and weaknesses. These vary in complexity and cost.

For an investor, the level of complexity is often less important than the application of a consistent set of guideposts which enable cross-company comparisons to be made.

Simplicity is desirable for the time poor investor seeking to summarise his attitude to a company quickly and without having to engage in complicated financial analysis.

*thebigpicture* sustainability overlay is one simple set of guideposts against which investors can judge a company being considered as an investment.

The overlay is part of a three stage analytical process to structure a portfolio which involves identifying:

- companies with a superior (and rising) return on their funds employed;
- companies which are likely, within a period of two years, to move from having returns below their costs of capital to returns above their funding costs; and,

***“thebigpicture rule of thumb is that it will not take into its value-driven investment portfolio any company with a low score...on any one of the four criteria”***

• companies whose prices reflect an achievable growth rate (based on the macroeconomic environment in which it is likely to operate over the medium to longer term).

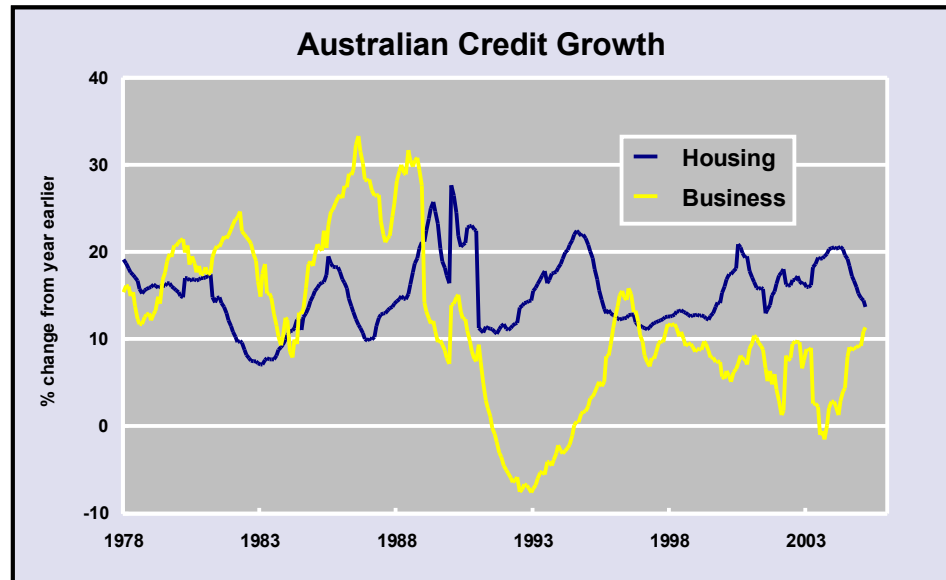
In choosing from companies meeting these criteria, the overlay can help assess the risk of the historical return not being maintained.

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Foster's Group Sustainability Test	
Is A Need Being Met?	0 <span style="margin-left: 100px;">x</span> 5
Can It Be Made?	0 <span style="margin-left: 100px;">x</span> 5
Can It Be Sold?	0 <span style="margin-left: 100px;">x</span> 5
Is It The Best?	0 <span style="margin-left: 100px;">x</span> 5

## THE WEEKLY CHART SPOT

*“Spending on additional productive capacity or outlays to improve business efficiency help to keep a lid on inflation and reduce the chance of the Reserve Bank pushing up interest rates.”*



Source: Reserve Bank of Australia

There is a switch in emphasis in Australian credit growth away from housing and toward funding business spending. This is a welcome sign.

The cyclicity in the pattern of lending for housing (shown in the blue line) has been a feature of Australian economic life for decades. However, a genuine housing sector recession is rare. Periods of 20%+ growth prove unsustainable but rarely give way to anything much below 10% a year. The last seven years have been somewhat peculiar because of the length of the expansionary period. Now, a clear fall in growth toward the rates normally associated with a cyclical downswing is underway.

The most striking feature of the history of business lending (shown in the yellow line) has been the recession-dominated early 1990s followed by the weak credit expansion throughout the following decade.

Weakness in lending to business through the 1990s reflected the balance sheet restructuring undertaken by more risk averse business managers as they came out of the recession and focused on reducing debt and funding their business needs with a higher proportion of internally generated funds. Excess capacity was also a feature of many businesses reducing the need for spending on expansion. Banks, too, came out of the recession chastened by the experience. There was evidence they opted for less risky lending for housing as they backed away from business investment spending.

A lengthy period of close to uninterrupted economic growth has meant more need for capacity boosting business expenditure. There are also pressures to reduce costs to be competitive. These factors are now showing up in the credit statistics. The banks, too, have reacted to the slowdown in their own businesses due to weaker housing investment by changing the emphasis in their marketing to give business lending a higher priority. In some cases, too, banks have seen opportunities from diminished customer loyalty to cultivate a higher share of the business sector at the expense of their competitors.

From the perspective of macroeconomic management, the switch in emphasis is beneficial. It makes the economic expansion more sustainable.

The multiplier effects from business investment spending are helpful in sustaining growth and compensating for the recent weakness in consumer spending generally. Spending on additional productive capacity or outlays to improve business efficiency help to keep a lid on inflation and reduce the chance of the Reserve Bank pushing up interest rates. Business investment is also less prone to be speculative (vis-à-vis the capital city apartment market) and, therefore, less likely to result in an asset price bubble (at least in the foreseeable future) against which officials must guard. ■

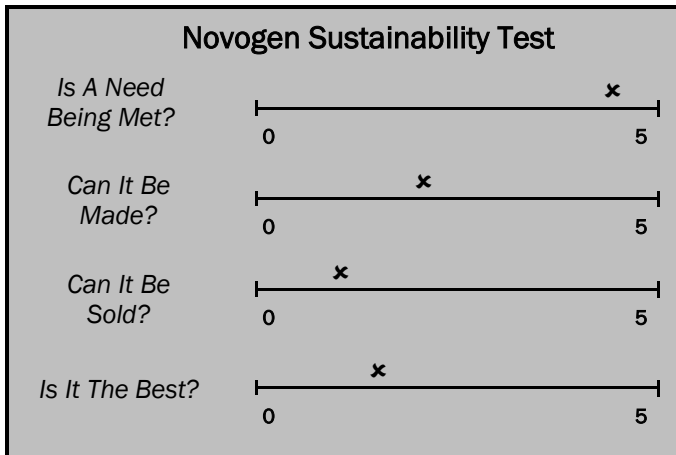
## CORPORATE SUSTAINABILITY GUIDEPOSTS CONT'D

(Continued from page 1)

The questions posed in *thebigpicture* sustainability test involve value judgements which might differ from investor to investor. Nonetheless, there is some worth to summarising the conclusions in this easily digestible form.

The process might also throw up questions on which further information could be sought to help better understand the actual positioning of a company.

To help illustrate how the methodology can be used, two companies with markedly different characteristics have been used as examples. One, Novogen, is engaged in the development of highly sophisticated anti-cancer treatments. It is a proxy for many of the early-stage biotechnology companies which are engaged in



research and product development as they set up international distribution.

The second company, Foster's Group, is one of Australia's longest established industrial companies and a manufacturer and distributor of branded alcoholic beverages.

#### Is A Need Being met?

Novogen will clearly meet a need. People will pay for a cancer cure. Governments will also partially fund purchases once drugs or treatments are placed on approved lists reducing the price sensitivity of the products. Within the limits found in an advanced industrial economy, demand will not vary significantly with incomes.

Foster's fulfils a very different sort of need. Its products occupy entrenched positions in the cultures of Australia and other advanced industrial countries. However, demand will be more price sensitive than for the cancer treatment. As incomes rise, the quantity of its products

sold can diminish even as total spending rises and consumers place greater emphasis on quality and premium branding. There is an element of lifestyle statement in the Foster's products.

The elasticity measures are a key determinant of whether a need is being met. In our examples, Novogen scores near the top of the range and Foster's somewhere in the middle.

#### Can It Be Made?

There is a doubt on this point among many of the early-stage biotechnology companies. Some of their products are barely past initial clinical studies with the scientific basis for production still being proven in some instances.

Even where the scientific basis for production is reasonably well-established, the availability of suitable production facilities may depend on other studies or on government approvals. There might be limits on where production facilities can be located because of the need for certain workforce skills.

Foster's, on the other hand, is using production techniques which have been long proven. In the case of beer, it is able to replicate quality in many locations not only in advanced industrial countries but also in developing nations with typically poorer industrial infrastructure.

#### Can It Be Sold?

Whether products can be sold will depend on:

- the regulatory environment and whether the company meets the standards required in a particular location;
- the existence of distribution channels for similar or competing products and how accessible they are to a newcomer;
- how much access the producer has to the ultimate consumer to influence perceptions about the product directly or whether it must operate through retailers or wholesale distributors.

For the budding pharmaceutical company, getting to market can be an insurmount-

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## CORPORATE SUSTAINABILITY GUIDEPOSTS CONT'D

(Continued from page 3)

able hurdle. Invariably, success depends on gaining acceptance in the key USA market and most Australian biotechnology companies seek to build partnerships with existing US-based distributors as a way of doing that. Sometimes, these partnering agreements have fallen short of what had been expected when there is insufficient incentive for the larger partner to push the new product into the market at the expense of its existing product range.

Foster's, on the other hand, has shown that, in the advanced industrial economies, it has been able to achieve significant market penetration starting from a small base in the case of its principal international beer brand. Wine has been more difficult because it has been less amenable to mass marketing. Nonetheless, Foster's and the Australian wine industry in general have been remarkably successful in gaining rapid market penetration offshore.

Domestically, the constraints are arguably greater. The "share of stomach" of the Foster's products is already high and the growing economic power of Coles Myer and Woolworths in the retail market is signalling that penetration could be limited unless it is prepared to concede more pricing power.

### Is It The Best?

There are four identifiable elements to a judgement on this guidepost.

- A unique branding proposition (or long lasting patent) allows a company to score high marks in this category. A producer of a generic or home brand alternative would be more likely to suffer from a lack of economic power with its financial returns subject to the whim of the eventual buyers.
- Output quality needs to be at least as good as anything else in the industry to score well with programmes in place dedicated to securing such a position. This would normally require attention to training and a commitment to speedily developing or adopting the latest technology.
- Production costs should be well below average or no worse than an industry

standard and, as with output quality, there should be overt signs of a commitment to maintaining this position.

- Having a position of strength (or even ownership) of the distribution channels would be an important sign. There is a stark contrast, for example, between the Foster's national beer distribution capacity in Australia which can reach nearly every licensed premise in the land and Novogen's ability, on its own, to reach the doctors and medical facilities in the USA which will determine the success of its product offering there.

### Making The Choice

The charts summarise where *thebigpicture* thinks the two companies sit on the scale for each of the four guideposts. In our illustration, Foster's generally ranks ahead of Novogen. Novogen is clearly superior in terms of its ability to meet a need. However, it ranks low on the scale in some other cases, notably whether its product can be taken to market.

Often, equity markets become fixated on one of these measures at the expense of the others. At some time, the balance quickly returns. When attention switches, it invariably comes with price volatility. A famous example of this is international pharmaceutical aspirant, Biota. The market switched from a focus on whether it met a need, on which it was highly rated, to a concern about whether its product could be sold. With that came a rapid (and permanent) deterioration in market price.

An investor conscious of these sustainability guideposts would not have been surprised by the switch in emphasis suffered by Biota and might have been better able to summarise the risks and structure a portfolio accordingly.

*thebigpicture* rule of thumb is that it will not take into its value-driven investment portfolio any company with a low score (i.e. in the bottom quartile of the range) on any one of the four criteria. A low score in any measure represents too great an investment risk making the company too highly speculative to qualify as investment quality. ■

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