THE NEED TO CONSTANTLY REVIEW THE ACTIVITIES OF THE DIVERSIFIED COMPANY

By J.K. Campbell

(Mr. Campbell is Chief General Manager of Hooker Corporation Limited. This address was delivered to a meeting of the New South Wales Branch of The Economic Society of Australia and New Zealand on 17 September 1970 and initiated a good discussion. Acknowledgement is made to Mr. Campbell and to the Society for permission to publish the address in this Journal.)

Introductory

I have been asked to speak with you generally on the principles underlying investment decisions. I thought it might be helpful if we considered the position of the diversified company and the decisions its diversity imposes. The truly diversified company, by virtue of its vastly different divisional activities, must constantly review its activities, and by activities, I mean its investments.

The term "investments" must imply the utilisation of capital in all its forms. It must also imply capacity, people and, in fact, the whole of the resources of an enterprise. In considering a new or existing activity, it will be just as important to consider that activity's drain on the executive and technological capacity of the business as it will be to consider its drain or effect on the financial resources of the business.

The Objectives of the Company

All investment decisions must fundamentally carry out the objectives of the enterprise as originally provided in the dominant clauses of its charter The investment or activity must, of course, also be within the laws of the country of operation and within the laws and powers of the enterprises' Articles of Association and similar documents.

In observing the above constraints, the decision makers must have regard to -

(a) the requirements and reasonable expectations of the proprietors (stockholders of the business) who have contributed risk capital for the purposes of gain.

(b) their responsibility to financial institutions, bankers etc. that have advanced funds, or may advance funds to the company to assist the company in profitably and effectively carrying out its objectives.

(c) their responsibility (and no mean one) to the large number of employees of the business whose present and future lives can be materially influenced and affected by their actions.

(d) their civic and economic responsibilities to the nation and to the community as a whole.

Over the years, there has been a tendency for many Directors to strictly adhere to the original"dominant objects" of "their" Corporation. Some have done this in the belief that this is what stockholders expect of them. I believe they could have been misled in this attitude and that their companies may have failed or fallen behind because of their inability to accept but more particularly, contemplate and plan for change.

The Memorandum & Articles of Association of most companies contain "dragnet" type clauses which give companies substantial scope in their operations. The Courts (rather correctly) have tended to frown on any abuse of these clauses. It is essential, therefore, that when changes are occurring or are expected, that the decision makers quickly recognise these and seek stockholders' and, where applicable, lenders' approval to new objectives. It is also important for the current and future objectives of the company or enterprise to be stated regularly, when and where appropriate.

The Nature and Character of the Investment or the Activity

I think that we must accept that all investment decisions must be subject to the powers and expectations I have just mentioned.

In considering expectations, it should also be accepted that what is a sound investment decision for a Mutual Fund, a Superannuation Fund or a Life Assurance Company could be vastly different to that of a highly speculative mining exploration company.

On this same subject of powers, discretions and prerogatives, one must also consider trusteeship and the responsibility that this imposes either through a particular deed or by the statutes.

It should thus follow that all investment decisions must be compatible with the particular character and expected character of the particular enterprise as regularly approved and stated. Decision makers who depart from these principles without specific approval so to do must bear the personal responsibility of their actions.

The Diversified Company

Most diversified companies in Australia, or for that matter throughout the world, have generally grown by way of takeover and/or merger. The new activities that have resulted from these various takeovers and mergers have not always been consistent with the dominant objects of the original company, even though the "dragnet" clauses of the particular charter may have made them legally permissible.

If a proposed new activity requires a significant investment of resources, and if it were a material departure from those activities for which stockholders (and lenders) originally believed they had subscribed capital and funds, I strongly believe that such material departure should be approved by stockholders in the customary formal way. This approval need not be a frustrating or inhibiting process. In advocating this approval, I must stress that I have in mind material changes only.

In considering with you the need to constantly review the activities of the diversified company, I am somewhat dominated in my thinking by the need for adaptability and for the need of an awareness that must embrace changes occurring or likely to occur in the particular industries in which the business is engaged. An awareness of the changes that are likely to occur almost demands clairvoyance which is not usually available.

We are all aware that what was once a sound activity may no longer be one, and this is not always a happy or easy realisation for the Board and Management to accept - there is often "emotional involvement" - we can all be guilty of this.

Certain of the presently successful activities may have little promise in the future because of the technological and market changes looming in the short to medium term - the decision makers must attempt to foresee and plan for this.

Some Yardsticks for Reviewing Activities and/or Investments

As your group is a discussion group, and as it is proposed to leave as much time as possible for discussion this evening, I have listed and have partly reiterated a number of matters which may be worthwhile our more fully considering a little later:

1. I have mentioned objectives and powers - the need to change these - with approval - where appropriate - and the need to state and restate the objectives.
2. The investments and activities should be compatible with what the company or enterprise purports to be.
3. Certain current divisional activities may appear economically satisfactory on the surface, but may be losing propositions in the future. All activities must be measured on a "consistent and fair" basis. This is not always done. When it is done, it often reveals the existence of a hitherto apparently profitable activity being heavily "subsidised" in various ways.

4. Most stockholders have contributed risk capital to an enterprise for the purpose of "gain". What stockholders expect in the form of "gain" will have to be very clearly defined and understood. Are they expecting early or medium to long term dividends? Is an earnings growth expected or is capital appreciation of the assets owned by the enterprise the dominating objective? Are stockholders seeking a balance of both?

   Capital profits within an enterprise will mean very little to the stockholder seeking increasing income by way of higher dividends unless such capital profits can be returned to him in tangible form or profitably reinvested by the company.

   The investment decision makers must carefully weigh up activities capable of producing significant capital appreciation (to the company) but moderate earnings almost in perpetuity. If the rate of earnings of a particular activity constantly increases, the value of the assets (depending on their nature) invested in such an activity should somewhat correspondingly respond to this, and if this is so, and the earnings are adequate, the continuation of the activity must be considered sound. There are, however, a number of activities the rate of earnings of which do not materially grow, and their retention is justified on the grounds of the capital appreciation on the assets involved therein. If stockholders invested in this basis, or approved of such an activity with the knowledge of the foregoing prospects, then the decision maker may feel justified, if even barely so, in continuing with the activity.

5. Most stockholders entrust their capital to Stock Exchange Corporations and Enterprises for the purpose of receiving secure but increasing dividends out of increased earnings, and as a consequence, seeing their stock investment appreciate in value.

   It must therefore follow that the continuation of particular activities and all investment decisions related thereto must be made with the object of increased earnings per share - now, or in the short to medium term.

   No activity should be permitted that cannot contribute by way of earnings, a rate of return equal to the minimum rate of growth expected of the overall enterprise. It does not dogmatically follow that this contribution to earning rate should be immediate, but one could be dogmatic about it occurring in the short to medium term - if the expectation of growth in earnings per share is the yardstick and basis upon which the proprietors have invested their funds.

Adequate Return

In assessing the adequacy of return of particular activities, consideration will have to be given to -

(a) the minimum rate of return required to meet stockholders' reasonable expectations - arising from prospectus promises or otherwise.

(b) the quality, safety and recurring nature of the income. It is strongly suggested, however, that these considerations should not outweigh the minimum test, and that is that the earnings from such safe activities cannot and must not be subsidised by more speculative and less secure types of income.

(c) the projected growth of the rate of income from the investment, particularly if such income and its rate of growth is secure - of quality and of a recurring nature.

(d) the future technological and market vicissitudes associated with the activity and when these could crystallise.

(e) the extent to which, in planning future profits and rate of earnings growth, certain activities can be "subsidised or supported" in the short to medium term with the knowledge that they will be excellent, as distinct from marginal, contributors in the future. This will involve "balancing" the "pot boilers" with the medium to long term potentially profitable ventures in order that overall servicing of the company's capital and debt is at all times satisfactory.

(f) leverage, and the extent to which the benefit of this will vary from activity to activity, particularly where specific as distinct from group overall borrowings are made.

(g) the true realisable value, if any, of the assets of particular activities using such value as the basis of calculating the earning rate. In some instances, the value may be "going concern value" only.

(h) the value and extent of taxation concessions such as those arising from investment allowances, export concessions, etc., and the effect of these on the net earnings per share, as compared with the profit from an activity not enjoying those concessions. There will also be the benefit of the profitable otherwise re-employment of the concession if it were of a cash nature.

(i) Medium to long term projects and the earnings forecast supporting these must be calculated to show the return on a discounted cash flow basis. The avoidance of reducing future income to the present day value of the dollar is probably the most common mistake made by decision makers in approving medium to long term investments. Too often, we see feasibility studies demonstrating excellent earnings in the long term following a significant drought of income in the intervening period - justified by the flattering apparent future returns not based on a reduction to the present day value thereof and the consequent significant reduction in the real return.

Yardsticks of Measurement

Australian corporations too frequently use the percentage earnings return on Issued and Paid Up Capital as their yardstick of performance. It suits them to do so. The main reason is that a return measured on stockholders' funds (which includes retained profits, reserves and other free monies) does not always survive reasonable tests. I say reasonable tests because most large public corporations do earn at least the Commonwealth Bond rate on their stockholders' funds but not much more. These corporations, the stockholders that support them, the general public, trade unions and our Government must condition themselves to the inadequacy and unacceptability of the returns demonstrated by this more proper yardstick of measurement.

You will all appreciate that a measurement of return of earnings on stockholders' funds in itself can also be extremely misleading depending on the extent to which a company has revalued its material fixed assets - upwards or downwards.

I believe that many diversified companies reviewing their activities could well find that the activities themselves may be quite worthwhile but that an excessive investment in fixed assets or similar assets renders the returns marginal. The solution to this need not be the abandonment of the activity, but a refinancing of certain of the capital components of the activity. I particularly refer to the need in certain instances for sale and lease-back of the heavy fixed asset investment in certain industries - such as retail.

If one were to be a little more specific on this question of need for constant review, one might pose the following questions in respect of certain particular activities of a company "close to home".

1. Pastoral:
   (a) Are the vicissitudes too great to ensure minimum average rate of return on funds employed?
   (b) What is the real value of the taxation concessions?
   (c) What is the discounted cash flow value of the potential future earnings after allowing for the cash value of the tax concessions?
   (d) Are the lands being put to their most productive and profitable current use?

(e) What is the future of wool prices? Should there be a partial or complete conversion to fat lambs? - What if everyone else does the same? - Its effect on the market, etc.

(f) What about cereal and other cash crops? Will wheat be in excess supply for some time? Will hard wheat be preferentially treated in terms of soft wheat? Could one grow linseed? - If so, what about the market for the product? If the season denies sowing and growing of a winter crop, can one be rescued by a summer growing crop such as sorghum, sunflower, etc? What about the market for this type of produce?

(g) What about cattle and the cost of converting to this? If the land is suitable for carrying beef for the "visible lean" U.S. market - what about the U.S. import quota - the Australian diversification scheme. If one improves the property and upgrades the herd to prime freezer quality, will there be a market for the beef - if so, where and when?

(h) Are there collateral advantages to the Company's overall activities by continuing in the industry?

(i) What is the realistic realisable value of the assets of the activity for the purpose of measuring the return thereon?

(j) Can one justify to stockholders a continuation based on capital appreciation alone? Is this what stockholders want?

(k) Can the funds employed be more securely and advantageously invested in more proven, more highly profitable other activities especially where experience, capacity, expertise and opportunity already exists in other divisions?

2. Hotels:

(a) What is a realistic realisable value of the assets? What is the current and projected return thereon?

(b) If the return is marginal, what "marks" do we give for:-

- (i) Cash Flow.
- (ii) A reasonably protected industry (to some extent) under existing licensing laws.
- (iii) relatively safe recurring income.

(c) If one is an owner/operator, could the return be improved by:-

- (i) Refinancing.
- (ii) Sale and lease-back of the heavy fixed asset involvement. Are purchasers available for this purpose?

(d) Is every hotel marginal? What is the effect of fixed overhead recovery if a partial divestment were made? Can this be rationalised?

(e) Would remodelling and renovations assist the rate of return? How often would these be required? What about amortisation and depreciation and the absence of taxation deduction for most of these real costs?

(f) Is management efficient? How can we compare?

(g) Will liquor price increases be granted in the future to coincide with specific increases in wage rates and other costs, or will delays recur?

(h) Is capital appreciation taking place? How does this benefit the proprietors (stockholders) of the business?

(i) Are there collateral advantages to the company's overall activities? If there are, these should be harshly measured.

(j) Again, can the funds be more profitably re-employed?

3. Land and Projects for Future Development:

(a) How many years ahead should one plan in terms of suitable stock?

(b) Can the group financially stand the temporary "dead weight" involvement and its effect on short to medium term profitability?

(c) If stock for future development were the lifeline of the business (and it is) - how should one finance? Should one create a "land bank" with a suitable institutional profit-sharing partner for a proportion of this valuable commodity? These decisions must be part of the balancing process.

(d) If one looks seven to ten years ahead, should one make great allowance for radical changes in living habits?

(e) What about the Government as a possible competitor? For example, industrial land.

Conclusion

It is not possible for any one individual to record by mathematical formula, or otherwise, the minimum returns which each and every activity of a business must earn. The returns may be"weighted and measured" by many, many factors - some of which I have mentioned.

In my opinion, the current and responsibly projected earnings of all of the activities of the diversified company should be strategically balanced together to produce an earnings per share growth - (assuming this to be stockholders' expectation). Any particular activity not capable of contributing to the minimum return within a reasonable period of time must be "culled" at the most advantageous moment, possibly as and when the opportunity presents itself. In some instances, it is preferable not to await the"moment" or the "opportunity".

****

A CRITIQUE OF ISSUES OF INTEREST

By "Rio de Oro"

(The following analysis was submitted on 1 March 1970 but was not published at that time. As indicated on the Editorial page, this particular issue may still be of interest and the contribution is therefore published now without alteration and without comment).

MORTGAGE UNDERWRITERS INTERNATIONAL LIMITED

Issue

Public offer of 1,380,000 ordinary shares of 50c each at par, in terms of a Prospectus dated 22.1.70. The issue was underwritten and listing arranged on Sydney and Melbourne Stock Exchanges.

Background

The Company follows a familiar pattern, being newly incorporated to acquire an existing operating company at a price far in excess of the net tangible worth and bearing no rational relationship to past profitability. In this case the new holding company was incorporated in New South Wales in September 1969, and by the date of the Prospectus had acquired the whole of the capital of Mortgage Underwriters of Australia Limited. Although the latter has made losses each year, and accumulated losses exceeded capital so that there was a net deficiency, the consideration given was -

420,000 fully paid shares of 50c,
$30,000 cash, and
500,000 options to acquire shares, exerciseable at par at any time within 5 years but after 1.7.1971.

Before the date of the Prospectus 200,000 shares had been taken up by subscribers or placed at par, allottees being given the right to take up 100,000 options at par similar to those referred to above. Provision was made in the operating company's accounts for the balance of $20,000 promotion fees payable to a Director, and in terms of an agreement reported in the Prospectus a further $50,000 is to be paid to him for refraining, for a period of 5 years after leaving the Company's employ, from competing with the Company. It is stated in