IEL'S OFFSHORE OPPORTUNITIES

An Address by

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It is probably fair to say that IEL is one of the best known but least understood companies in Australia. For those not familiar with the IEL story, our business philosophy is very simple — to maximise the return to our shareholders through expansion by the acquisition of companies at a discount to their true net worth. During its first 20 years, IEL has been able to achieve a return on shareholders funds of approximately 50 per cent per annum which, according to The Sydney Stock Exchange Research Department, is the best record of any listed company during the period. One thousand dollars invested in IEL 20 years ago would today be worth just over four million dollars. If this growth rate is to continue and allowing for a 2:1 gearing ratio, then each investment by IEL must achieve a combined earnings yield and increase in capital value of around 30 per cent per annum.

The Brierley business philosophy has also been used elsewhere with similar results. IEL's ultimate parent company, Brierley Investments Limited (BIL), has grown to become New Zealand's largest company since commencing business in 1960. I believe this was only possible because Ron Brierley perceived the need at a very early stage to have access to investment opportunities outside New Zealand. Accordingly, in 1966 he acquired IEL as his investment vehicle in Australia. In the ensuing 18 years, IEL grew at an even faster rate than BIL to now be capitalised at in excess of 800 million dollars or 50 per cent more than our parent company. In a similar way, we will be looking to our subsidiary, industrial equity (Pacific) Limited, to maintain IEL's growth rate in the future and to overtake IEL within the next ten years.

Industrial Equity (Pacific) Limited is owned 81 per cent by a subsidiary of IEL and is the vehicle by which IEL does all its offshore investing. It is a public company listed on The Hong Kong Stock Exchange and was taken over by IEL in 1975. Students of classic takeovers may be interested in the following brief history of Industrial Equity Pacific.

The company was formerly known as Shanghai Dockyards Limited. When IEL took over the company in 1975, it had two major assets. Firstly, it owned and still owns land, buildings, wharves and docks in China at a 1935 valuation of 14 million dollars Hong Kong — this represents one of the largest dockyard complexes in the world.

Unfortunately, the dockyards were nationalised by the Communist Chinese in 1952. The second investment was about 2.5 million dollars Hong Kong invested in the United States, which had been blocked by the US authorities in retaliation. IEL has since unblocked the assets in the USA and re-invested the proceeds. A claim for recovery of its assets in China has been lodged with the relevant authorities. In the meantime, the assets in China have been written down to 1 dollar Hong Kong in IEP's books.

Industrial Equity Pacific is the vehicle through which IEL has undertaken all its offshore investment since 1975. Currently, IEP has one operating subsidiary — the Higbee Company of the USA, acquired in 1984 at a cost of 70 million dollars US. It has an annual turnover of 250 million dollars US, 5,000 employees and operates 11 regional department stores in Cleveland, Ohio. In addition, IEP has 12 public company holdings which have already been disclosed overseas. There are seven such investments in the UK;

Tozer Kemsley and Millbourn, a car importer and distributor, of which IEP owns 25 per cent. Our holding in TKM is currently worth approximately 4.5 million pounds.

Ratcliffs Great Bridge PLC, a manufacturer of copper and brass sheeting, where IEP's 9 per cent holding is currently worth 590,000 pounds.

Jonas Woodhead and Sons PLC, a manufacturer of springs. IEP's 10 per cent holding is worth 360,000 pounds.

Redfearn National Glass, where IEP's 5.1 per cent holding is worth 250,000 pounds.

William Sommerville and son, a paper Manufacturer. IEP's 21 per cent holding being worth 206,000 pounds.

The Concordia Electric Wire and Cable Company Ltd. IEP's 7 per cent holding is worth 81,000 pounds.

And finally, The Dart Valley Light Railway Company. IEP owns 7 per cent and this has a current market value of only 16,000 pounds.

In the United States, there are five publicly disclosed holdings, as follows:

Firstly, Consumers Water, a water utility in the New England region, where IEP's 10 per cent holding is worth 4.75 million US dollars.

Central Pacific Corporation, a Californian bank. Our 6 per cent holdings is currently worth 1.05 million US dollars.

Pacific Cement Investors, where IEP owns 18.5 per cent of the "B" class shares, having a current market value of 500,000 US dollars.

Package Machinery Company, where IEP's 5.2 per cent holding is worth 350,000 US dollars.

The final disclosed holding in the US is Frawley Corporation, a diversified company operating stop smoking and weight control centres, three hospitals for drug addiction and publishing two Catholic newspapers. IEP owns 7 per cent of the shares, which are currently worth 340,000 US dollars.

There are another 22 US stocks and 37 UK stocks in which IEP has an investment but the holding is still below the 5 per cent disclosure threshold.

IEP has only one small investment outside the USA and the UK and we intend concentrating our offshore investment activities in these two countries. We see the main advantages of investment in the USA as follows:

- Firstly, the size of the market. There are over 6,000 companies in the USA capitalised at over 100 million dollars, compared to just over 100 companies of this size in Australia. Viewed another way, the USA has 53 per cent of the world's equity markets compared to Australia's 1.8 per cent.
- Another advantage is the apparent pre-occupation of US investors with earnings. P/E ratios fluctuate wildly between 5:1 and 50:1, depending upon the perceived profitability of the company. As a result, the USA breeds exceptional discounted asset situations. In many cases, we believe we have paid less than 10¢ in the dollar, especially when buying the first few shares in a company. For example, we bought our first shares in Higbee at 9 dollars per share in August 1980 and we bought the last shares at 50 dollars in October last year. 50 US dollars was still a considerable discount on the company's true net worth.
- The tax on property revaluations in the US leads to undervalued properties in the balance sheet. Also, the tax benefits for capital expenditure and accelerated depreciation reduce book values even further.
- The USA has probably the best statutory analytical information available anywhere in the world. Those of you who have read a 10K report from the US will know exactly what I mean.
- US companies have large L.I.F.O. reserves and therefore artificially depressed earnings compared to Australia
- The final major advantage of investing in the USA is the fact that there are an exceptionally large number of provincial and apparently unresearched companies in the US.

We are realistic and experienced enough to know that investing in the US also has its disadvantages. The US tendency to litigate first and think later does concern us. Perhaps lawyer led recoveries in the US will, in due course, be replaced by some other form of economic stimulus. The second main disadvantage in the US is coping with distances, both from Australia and within the USA.

Now turning our attention to the UK. The main advantages are as follows:

- The UK market is significantly larger than Australia's. The UK accounts for nearly 8 per cent of the world's equity markets, which is nearly five times the size of our own.
- The UK has a similar legal and commercial environment to Australia.
- There are a multitude of old and redundant companies and rationalisation possibilities in the UK.
- Many UK companies have world-wide trade-marks, commercial ties and industrial agencies.
- The final advantage we see in the UK is the large number of provincial and unresearched companies.

On the other hand, the disadvantages of investing in the UK would include:

- The very high level of redundancy repayments.
- The ability to lose money and therefore net asset backing rapidly — both in respect of operations and write-offs.

- and finally, after completing months of detailed research on potential companies, it is often hard to "get set" — i.e., to buy meaningful quantities of stock once the analysis is completed.

IEL's offshore investment opportunities are nearly always identified and researched internally, mainly because of the depth of research required and our concentration on true net worth. There are various publications available within both the USA and the UK which highlight discounted asset situations, however the depth and emphasis of research has to date been inadequate as far as we are concerned. Accordingly, we currently have one full-time analyst specialising in the investigation of US companies and two part-time on the UK market. This compares with only two investment analysts concentrating on the Australian market at the moment — which serves to highlight the importance we place on offshore investment opportunities.

In view of the recent movements in the Australian dollar and our increasing offshore investment activities, I should spell out IEL's attitude to managing its foreign currency exposure. The philosophy is simple. Borrowings are made in the same currency as the investment so that there is no currency exposure at the time of investment. Subsequently, any increase or decrease in the value of each investment is not hedged. Therefore, as IEL's net equity in the US and the UK grows, so will IEL's exposure to sterling and to the US dollar. this policy has proved most successful to date but is being kept under constant review.

For those not familiar with industrial equity (Pacific), we announced the following series of capital changes in Hong Kong last month which will have the effect of increasing the capital of IEP from 9 million to 100 million shares on issue:

Firstly, a rights issue to existing shareholders of two new shares at 5 Hong Kong dollars for each share now held.

Then, after completion of the rights issue, a bonus issue of two shares for each share held (including those allocated under the rights issue).

Finally, after completion of the cash and bonus issues, an offer by tender of 19 million shares. The placement of these shares is in response to the fact that turnover in IEP is very thin, resulting in IEP's share price rising from 3.10 to 170 dollars Hong Kong — adjusted for the rights issue — in the last 12 months. This was, no doubt, due to a growing number of Australasian investors becoming aware of the role and potential of IEP within the group.

Before concluding, I would like to set the record straight about IEL's opportunities in Australia and why IEL needs investment opportunities offshore. We believe there will always be oportunities in Australia for companies like IEL. In spite of what has been reported in the press, I believe there are still numerous opportunities here, without even considering those companies that will make themselves available some time in the future. If IEL were restricted to opportunities in Australia, we could continue to make a very reasonable living for many years to come. The need to go offshore arised from our desire to *maximise the return* to IEL shareholders. In other words, our offshore opportunities appear to have more potential than many of those available locally. This is continually misreported as Australia having run out of investment opportunities.

In conclusion, I believe that IEL has the business philosophy, the people and the investment opportunities to maintain its growth rate for well into the next decade. IEL does have an ambitious expansion program for the future but one which is based on reality and sound experience. We are confident of providing our shareholders with consistent growth for a long time ahead, largely as a result of IEL's offshore investment opportunities. If indeed IEL can continue investing offshore successfully, not only will IEL's shareholders reap tangible benefits but so will Australia as a nation.