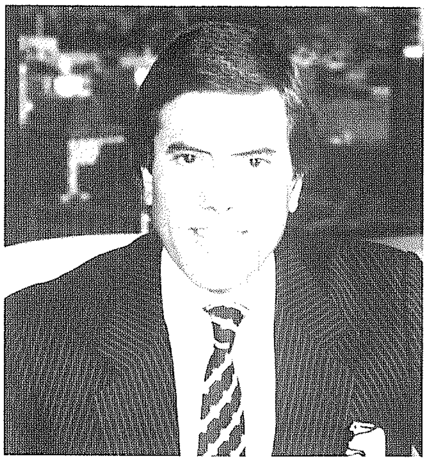
AN AMERICAN EXPERIENCE

ESCAPING THE TYRANNY OF SCALE



by CHRISTOPHER C. SKASE

The realisation that the prospects for growth for Australian business were hobbled by the country's size led an Australian company on a two-year search for opportunities in the United States. The result of careful analysis and planning is the promise of significant expansion.

Qintex America was born in my mind during a hot August in California in 1984. The primary purpose of my visit to Los Angeles was the Summer Olympics. However, my interest in business quickly over-rode the significance of the Games.

In a period of 10 days, my wife and I travelled extensively throughout the State, looking, listening and talking with people in business, with a particular emphasis on media and communications, and resorts and leisure.

Like most young Australian businessmen, I had been injected during education, with a number of so-called fundamental facts about Australian business and the historical limitations to the development of industry in Australia. The expression that I most vividly recalled from my school days was "tyranny of distance".

This expression has been one of the best-perpetuated myths in Australian history. After 10 days in California in 1984, I realised that the primary constraint to the growth of any company in Australia was not tyranny of distance, but tyranny of scale. That is, the absence of a population mass of a size necessary to participate realistically in the vast majority of the world's growth industries.

California has a population of 26 million and an annual GNP substantially higher than all of Australia, generated from one of the 10 biggest economic units in the world, which has produced a superior growth rate over a sustained period.

Based on the current population growth rates, Australia's population of 16 million will grow to the Californian level of 26 million by about 2040 — that is, in more than 50 years from now.

Those statistics assume greater dimension when you consider that California represents barely 10 per cent of the total population of the United States. The stark realisation that Australia would never be a major market force in world business, other than in mining and pastoral-agriculture, was the bottom line from those 10 days in California.

That experience was the start of two years of extensive and intensive research into areas of opportunity in the US.

We started with a clean sheet of paper, eliminated preconceptions and resolved to take as long as necessary so that when we commenced our investment program we would have a comprehensive and clear picture of the economic, social and political fabric of America; and of those States and sectors of the economy which would outperform the national average.

Twenty-four months of travel and desk research produced the answers.

The most consistent message from the research was that the American economy, in most traditional business sectors, is mature; the population is skewing adult; life expectancy is increasing and the adult sector is heavily preoccupied with information, entertainment and recreation.

We took our findings down two paths — specific business pursuits and areas of

Christopher Skase is chairman of Qintex Limited. This is an edited version of an address to the Victorian Division of the Securities Institute.

geographic focus. We decided that the preferred business fields were media and entertainment, and resorts and leisure, and that the most favourable geographic areas were the west coast (California and Hawaii), Texas, Florida and the North-east (New York-Boston).

Late last year we established Qintex America Limited, to commence operations and investments from January 1 with an initial fund of $250 million.

Our opening strategy was to identify two publicly listed companies, one engaged in media and entertainment and one in resorts and leisure, with established management and cash flows and significant potential for growth.

From a long list in each category, we identified Hal Roach Studios (media and entertainment) and Princeville Development Corporation (resorts and leisure).

Hal Roach Studios has a history as long as Hollywood.

A pioneer in black-and-white movies, including Laurel and Hardy comedies, the company became virtually dormant more than a decade ago.

Initially a group of Canadians invested in Hal Roach. They were subsequently approached in 1985 by a management team headed by Mr Hal Gaba who was a key figure in Embassy Communications. Embassy Communications was built from nothing to $500 million in a little over a decade before takeover by Coca-Cola.

I realised that the primary constraint to the growth of any company in Australia was not tyranny of distance but tyranny of scale.

Hal Roach, we concluded, was an ideal medium for entry into the media and entertainment industry in the United States. The outstanding features were:

- Established name;
- New management team with an excellent track record;
- Excellent portfolio of media and entertainment assets;
- Potentially high yield from investments in Colorization Inc., the film-colouring technology company, and Robert Halmi Inc., the New York film production company;
- Significant scope for increased earnings from the existing asset base;
- Ability of the management team to accommodate a substantially enlarged business framework.

Our opening strategy was to identify two publicly listed companies, one engaged in media and entertainment and one in resorts and leisure, with established management and cash flows and significant potential for growth.

A further advantage was that with headquarters in Los Angeles, home of the media and entertainment industry, the company was geographically accessible to the east coast of Australia.

Finally, a total investment of approximately $A85 million for a little over 51 per cent was consistent with the parameters which were established with the formation of Qintex America.

The key assets of Hal Roach are:

Film library. The library comprises 1,000 film titles in three sections — the original Hal Roach library, acquired film rights and public domain films. The superior black-and-white films in the original library are being progressively coloured. This is a growing source of reliable income.

Film production. Through Robert Halmi Inc., in which Roach is the largest shareholder with 22 per cent, the company has an interest in film production. Halmi, which is based in New York, has a long history of success, particularly with movies made specially for television. The Halmi formula is to develop the concept, then pre-sell to US networks, before production, for two runs, with Halmi keeping all the back-end rights. Roach distributes the Halmi product, once off network, earning 40 per cent of gross revenues. In the current fiscal year Halmi will post revenues of $A60 million and net profit of $A8 million.

Film Colourisation. In the US there are tens of thousands of black-and-white movies capable, until recently, of generating only modest income. Now two companies have developed technology for colouring black-and-white films.

Color Systems Technology Inc. is one, having developed a system based on computer hardware. This company is publicly listed and capitalised at about $A120 million. CST's colour system is optically and technically inferior, in my opinion, to Colorization Inc., the Toronto-based company in which Roach has a 49.5 per cent equity at a cost of $A1.5 million.

Colorization's system is software-driven, with a strong depth and spectrum of colours which are improving with every film.

In the past 12 months, Colorization has grown from 25 employees and three production lines to 120 employees and 18 production lines, with the facility working seven days a week.

Colorization's economics are now excellent. Direct costs of colouring a black-and-white film are $A200,000. Early sales indicate first-year revenues of about $A1.5 million: instant payback with profit and the creation of a virtually infinite stream of new earnings.

Film distribution. From the Hal Roach library, Robert Halmi, Colorization and acquired film rights, Roach distributes to television, home video, pay/cable, and specialist non-theatrical markets.

Television. Roach acquired interests in two television stations in Milwaukee, Wisconsin, (28th largest broadcast market) and Birmingham, Alabama, (47th) at bargain-basement prices late last year, in the aftermath of deregulation which started in 1984. It is instructive, in the context of the overheated nature of Australian television station prices, that prices of US television stations are down about 33 per cent from the peak early in 1985.

Quintex America holds 12.5 per cent of Roach and is finalising documentation to lift this, by placement and purchase from the present controllers, to slightly above 51 per cent.

Roach is an outstanding entry into media and entertainment in the United States. Net average cost will be $A11 per share and we are projecting earnings of between 90 cents and $A1 in the first full fiscal year (fiscal 1989) — an entry price earnings multiple of 10-11, well below media multiples in Australia.

Forbes magazine, in a recent article, noted a sharebroking company's forecast of earnings of $1.85 per share in year 2, which would reduce the multiple to 5½.

Hal Roach, as are all media and entertainment companies, is inevitably measured as an earnings stream, with one defect — an absence of hard, tangible assets.

To cover this defect and to produce the balance to our investment thrust into America, we sought to identify a resorts-and-leisure vehicle which was long on bricks and real estate.

Princeville Development Corporation is that entity, sitting with a strategically valuable position in Hawaii, the most dynamic tourist market in the Pacific.

In Hawaii, where large landholdings are very rare, Princeville owns 7,000 acres of freehold property on the island of Kauai. Kauai ranks number three, in annual tourist numbers, after Oahu and Maui and last year recorded the largest rate of growth in all of the islands. The Hawaiian tourist industry recorded 1.7 million tourists in 1970 and the annual inflow reached 5 million — a growth of 200 per cent in a little over 1½ decades.

Princeville was originally acquired by a group with oil and gas interests in Denver, Colorado. With a decline in oil prices, this group progressively reduced its influence.

To produce the balance to our investment thrust into America, we sought to identify a resorts-and-leisure vehicle which was long on bricks and real estate.

Princeville is an ideal vehicle for investment in resorts and leisure. It has a unique land holding which will produce substantial cash flows, profits and capital gains. There are existing cash flows from a resort hotel, retail interests, golf course, condominiums and real estate sales. And sunk costs in infrastructure such as power, water and sewerage will boost the rate of return from subsequent development.

The key assets of Princeville are:

- 42.4 per cent, rising to 70 per cent, equity in the Sheraton Princeville Hotel, a beachfront resort hotel which has been very successful.
- A 27-hole world championship golf course, which last year accommodated 70,000 rounds of golf and which is intended to expand to 63 holes.
- Princeville Centre, with 66,000 sq. ft. of retail space and plans to expand to 140,000 sq. ft.
- Princeville Management, which generates fee income from managed condominiums of which 1,200 have been completed and sold.
- Princeville Realty Corporation, which is principally involved in the sale of housing lots and condominiums;
- Princeville Airways, which operates between Honolulu and Princeville;
- Six thousand acres of underdeveloped property, adjacent to the property already developed.

Qintex America holds 5 per cent of the shares in Princeville, acquired at an average cost of $A13.50, which is about 50 per cent of our assessed net asset value. We have launched a tender for additional shares which, when coupled with a placement, will give us 51 per cent at an average price equal to 65 per cent of net asset value. Total investment will be about $A85 million for control of the company which has net assets of $A230 million.

Revenues in the first year are projected at $A25 million with net profit of A$5 million, which will rise quickly to $A10 million over three years and continue rising over the following three years to a target of $A20 million.

In Princeville, we are acquiring a controlling equity, at a discount of about $A30 million on net asset values and an outstanding springboard into resorts and leisure in the US.

Quintex America has 66 million fully-paid shares on issue. The shares were issued at $1 supported by a cash asset backing of $1. They are arguably worth over $2.

Two notional adjustments are: Hal Roach: apply a prospective multiple of 15 — add $39 million. Princeville: adjust for the discounted purchase of tangible assets — add $30 million.

Qintex Limited, the parent of Quintex America, has posted an average annual return to shareholders of 45 per cent over the past 10 years. The primary objective of Qintex America is to exceed this performance. Achievement of this objective would value Quintex America at around $30 per share, by year ten. The commitment to the American endeavour is as fervent as our commitment to Queensland over the past five years. □

MEANWHILE BACK AT THE RANCH...

Mr Christopher Skase reinforced his drive into the communications and leisure industries — and at the same time became one of Australia's top-level media owners — when in July he took control of the television interests of John Fairfax Ltd.

In a deal brought to fruition in little more than two weeks, Mr Skase bought Fairfax's Seven network — HSV7 Melbourne, ATN7 Sydney and BTQ7 Brisbane — for $780 million.

In the fashion now typical of high-rolling acquisitions, negotiations between Mr Skase and the Fairfax group general manager, Mr Greg Gardiner, went on by international telephone and finally across a desk at the Fairfax Sydney headquarters. Signatures were exchanged at 2.30 am on Friday, July 24 (a few days earlier, Mr Skase had been relaxing in an African game-park).

Fairfax had a choice of buyers for the stations, but little choice about selling. Federal media regulations made it impossible to retain the Melbourne 7 channel, acquired only months ago, during the tumultuous redistribution of newspaper and television properties which followed Rupert Murdoch's absorption of the Herald & Weekly Times organisation.

Media comment suggested that Fairfax had overpaid, at $320 million, for the Melbourne station, which was operating at a loss — but both parties in last month's sale expressed satisfaction with the deal.

Mr Skase said: "I took the biggest punt of my commercial career. . ." He also said that he expected TV operations to add $20 million to the Qintex net profit in 1987-8.

The Fairfax management expressed satisfaction with the way the television divestment had been structured: in a complex scheme of trade-offs, Fairfax will invest $100 million in Skase's United Telecasters which will later be converted to a 15 per cent interest in Qintex Limited.

Qintex's outlay is in the form of $25 million deposit, $470 million by November 30, 1987, and $285 on August 31, 1990.

In media stocks, activity breeds activity: Mr Skase will now have to dispose of his existing Channel 0 in Brisbane. □