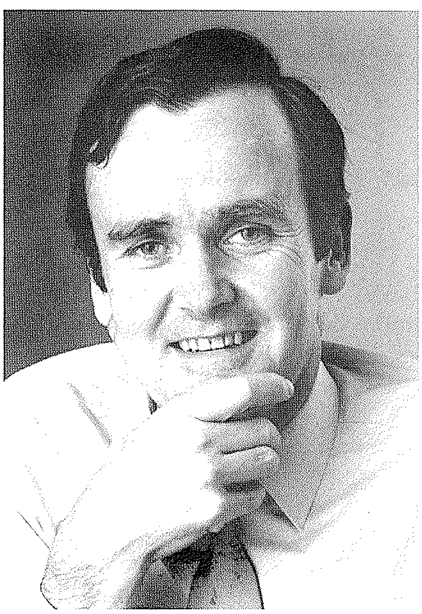
CLEANING UP THE CORPORATES

ENTREPRENEURS' JOB IS NOT YET OVER



by R.A. FERGUSON

The dominant role of entrepreneurial managers in corporate activity before last year's sharemarket crash has been criticised as a factor in the collapse. But much of benefit has come from their shake-up of corporate structures.

October 20, 1987, heralded the end of one of the longest bull markets in financial history. It ran from 1975 to 1987 with only a slight, but very nasty, interruption in 1981-82.

Any bull or bear market is influenced by the rise and decline of its key participants. These normally include the corporate sector, the banks, institutional investors, the public and the government in its regulatory and economic management role. The bull market just completed was heavily influenced by changes in the structure of the corporate sector, financed by the banks and fuelled by the institutions. The public was a minor element in the cycle, given the tendency of retail investors to move to pooled funds while the Government, via economic policy and financial deregulation, played a strong stimulatory role.

The most notable feature of the final 1983-1987 leg of the bull market was the increasingly dominant role of a new managerial class, the "entrepreneurs," in both domestic and international corporate activity.

The rise of the Australian entrepreneurs can be measured by their share of total market capitalisation. The aggregate market capitalisation of the dozen major entrepreneurial holding companies increased from 2.6 per cent at the start of the period to a peak of 8 per cent in mid-1986. The figure has since halved to 4 per cent and is likely to decline further (see Graph 1).

At their peak the entrepreneurs had a market capitalisation approximately the same as BHP's. If the entrepreneurs' market capitalisation is expanded to include their listed associates, the same trend is evident. The exposure peaked at 12 per cent in mid-1986.

The aggregate assets of the dozen entrepreneurial holding companies increased nearly ninefold from $4 billion to $32.1 billion in the period (see Graph 2).

The banking sector was the major financier and funded more than 60 per cent of the asset expansion of the entrepreneurs. Equity raisings accounted for 16 per cent and retained earnings and revaluations provided more than 11 per cent of the total (see Graph 3).

The emergence of the entrepreneur was a rational response to corporate behaviour in the deteriorating economic environment of the 1970s.

Following sound corporate performance in the favourable post-war economic environment, the professional manager was in his heyday in the early 1970s. Accordingly, the growth impulse of the corporate sector was at its peak but the slowing economy provided little growth to satisfy this need. In a bid to sustain corporate growth in the slowing environment, professional management pursued a policy of business diversification by takeover.

The result was the corporate conglomerate of the 1970s, characterised

Rob Ferguson is managing director of Bankers Trust Australia Limited. This is an edited version of his address to a Securities Institute conference on the theme of The New Investment Landscape.

by a highly centralised head office controlling groups of often ill-fitting and poorly co-ordinated operations. This was the last thrust of a business community dominated by managers rather than owners.

The professional managers ignored all the evidence which suggested they were excessively optimistic in believing they could transfer skills learned in one kind of business to another. As Warren Buffett, the US investor, has noted: "Our conclusion is that, with few exceptions, when a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact." Diversification was a classic example of organisations looking after themselves rather than the business of the owners.

Growth is, of course, important to the professional manager because it allows career opportunities to expand. As Harold Geneen, Chairman of ITT in the growth era of the sixties, remarked: "A company has a momentum of its own. When you have an organisation you need room for people to expand and to grow into new jobs. I always say there is one word for happiness in a business organisation: growth."

Thus, for the professional manager, the desire to expand was not a business goal but an organisational imperative. If that coincided with an economic environment where growth in a macro-economic sense was available, then there would be a healthy coincidence of interests between owners, managers and the economy.

In fact, this common interest, with some interruptions, coincided all the way up to the early seventies and ended with the bear market which signalled the end of the great post-war growth boom. As with most growth eras, it was inflation and the subsequent excess capacity which returned the economy to slow growth.

The short, sharp market setback of 1981-82 revealed the hollowness of the growth and diversification phase and marked the end of an era that went back to the thirties. The new era would feature a restoration of ownership and control via professional managers holding significant equity positions, i.e. the rise of the entrepreneurial owner.

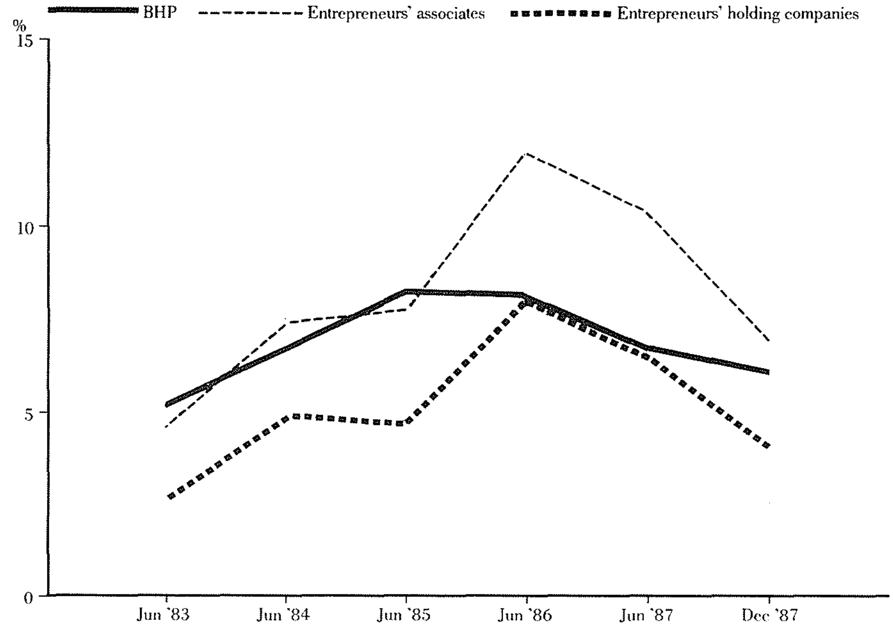
The scene was now set for a new class of entrepreneurs to undo the excesses of the professional managers. Their investment policy was that the sum of the corporate parts was more than the whole group, because of past mismanagement.

In practice, the entrepreneurial managers were more portfolio managers than business managers and they were able to add value through:

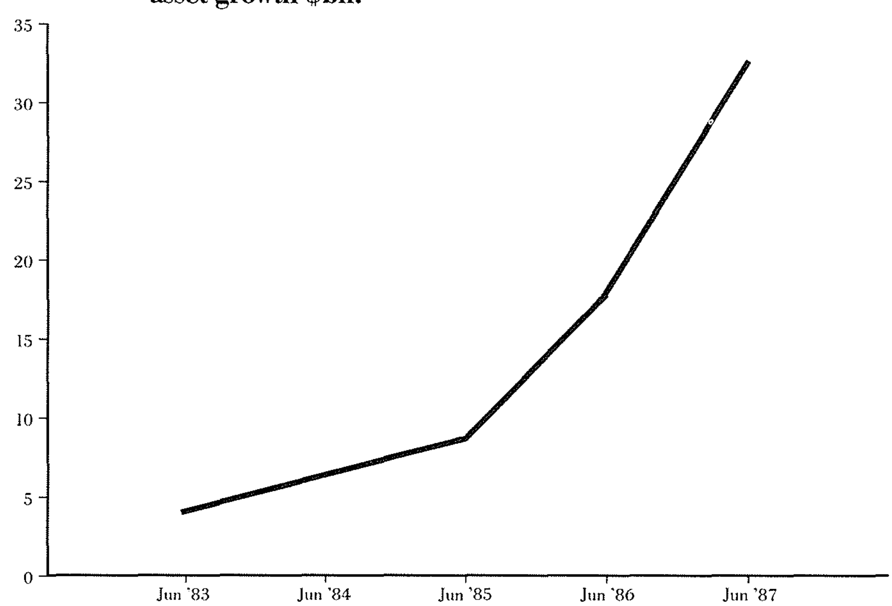
- Identifying core businesses that could be significantly enhanced by decentralised, profit-motivated management;
- Rationalisation of fragmented industries to reduce excess capacity and create oligopolistic competitive environments; and
- Minimising the takeover purchase price and maximising the disposal value of surplus assets through well developed financial and tax structuring skills and stockmarket awareness.

Given their portfolio management skills, it was natural for the entrepreneurial managers to work in relative harmony with the controllers of capital, the investment institutions. The institutions had in the seventies been subject to competitive forces which made them much more conscious of their role as shareholder representatives. Their frustration over the poor quality of professional managers was thus able to be eased by the allocation of equity

GRAPH 1: Market capitalisation.



GRAPH 2: Entrepreneurs' holding companies — asset growth $bn.



funds to the emerging entrepreneurial managers.

The business emphasis of the entrepreneurs was on cleaning up rather than new investment. From a macro-economic viewpoint, the entrepreneurs were not great creators of new investment but this should not be lamented. It was a rational response in an economy which was suffering excess capacity and needed enhanced efficiency from existing capital rather than creation of new capital.

In the 1983-87 period, the food, retail, pastoral, beer, wine, milk, container, heavy machinery distribution and media industries saw beneficial rationalisation that led to greater efficiency. Takeover activity in this period totalled more than $15 billion in market-value terms.

The industry rationalisation is still going on and is likely to continue. It was aided by Government economic policy which created excess domestic economic stimulus. The resultant buoyant domestic economy generated business optimism despite the deteriorating national economic fundamentals.

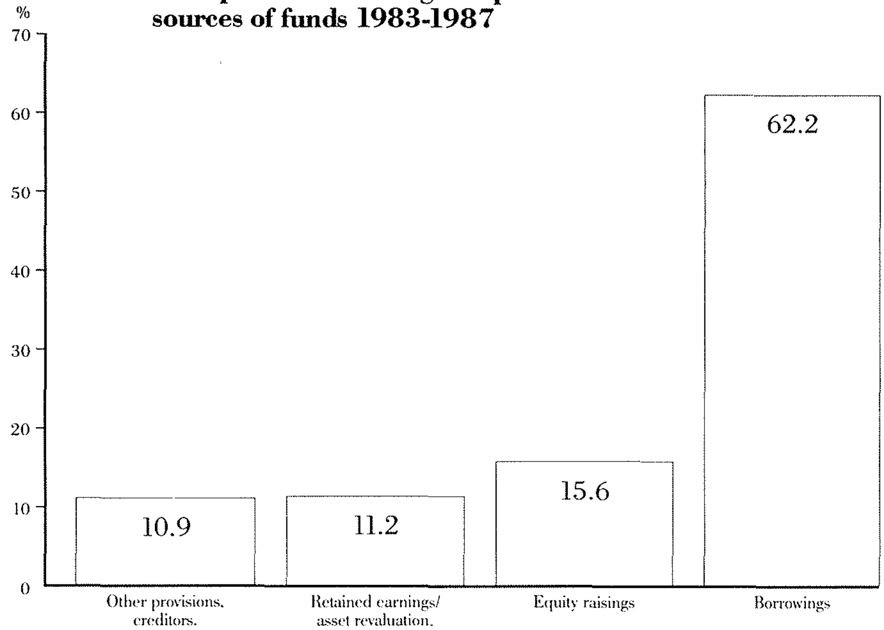
At a time when investment and management ability should have been swinging at a greater rate to export development and import replacement, the entrepreneur was generally concentrating on naturally protected domestic businesses that could be rationalised under Australia's benign trade practices regime. This was a consistent response to the Government's dubious credo of big unions, big Government, big business.

Where the Government provided a de facto export incentive via the tax-free status of gold mining, entrepreneurs invested in their droves. However, in general, the entrepreneurs concentrated on building oligopolistic businesses that accorded with the way the Government saw the economy developing.

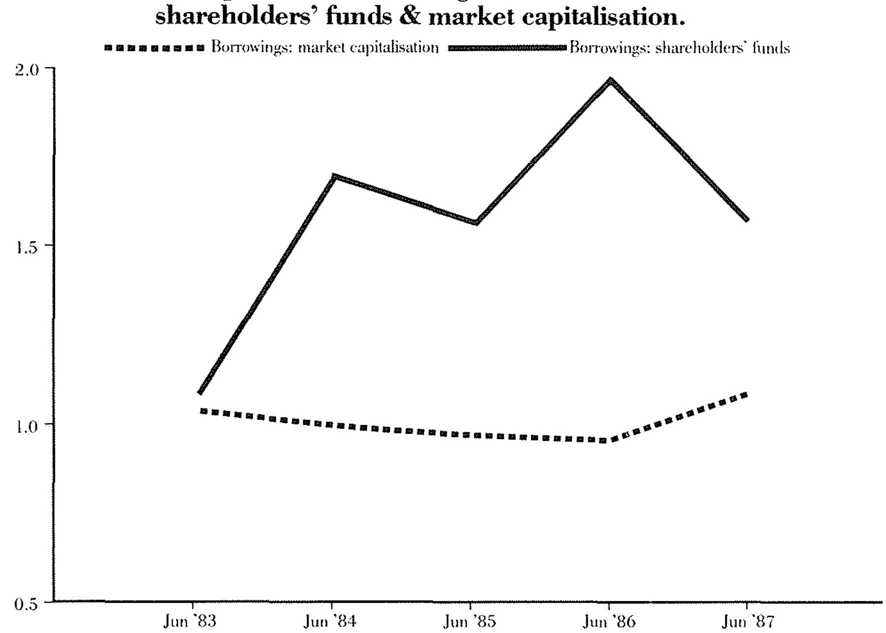
In the end, the sheer magnitude of success of the entrepreneurs was their downfall.

In any open financial market where super-returns are achieved, new participants will be attracted until returns move to normal after a period at subnormal levels. This trend was clearly observable throughout the last few years as new entrepreneurs emerged, especially from New Zealand (or "the land of puts", as it is known). The process produced a situation where the entrepreneurs were the driving force in the price level of the stockmarket.

GRAPH 3: Entrepreneurs' holding companies — sources of funds 1983-1987



GRAPH 4: Entrepreneurs' borrowings — shareholders' funds & market capitalisation.



This pricing power was first revealed, in my memory, in 1985 when Bond Corporation acquired Castlemaine Tooheys at what looked like a very high price-earnings multiple. However, the Bond purchase merely reflected a valuation, accepted by the bankers, based on the gearing potential of the relatively ungeared Castlemaine Tooheys group and its full-tax-paying status. In addition there were some then seemingly optimistic but now proven assumptions on what buyers would pay for assets to be sold.

It was around this point that the market started to price stocks not on their current and future earnings potential but on their potential to be taken over. It usually involved the introduction of gearing and tax-sheltering potential into a valuation, as well as an estimate of what excess assets could be sold for in a rising share market.

It is easy, in retrospect, to see why the crash came. For the entrepreneur, the seeking of value became harder simply because the market was increasingly more expensive. If he had stuck to his model he would have cut back and waited for value to return. However profits, if not value, were still there in a booming stockmarket that now hung on every word uttered about the entrepreneurs' intentions.

So, despite the knowledge that they were playing with fire, the entrepreneurs kept buying and dealing and raiding. Their asset bases continued to expand rapidly notwithstanding the increasing maturity of the bull market.

At the end of the day the entrepreneurs came unstuck because they got away from their original objective. That had been the legitimate task of cleaning up excesses of the previous boom. They did much of that, but when those opportunities diminished they started to believe their own public relations and saw themselves as smart sharemarket traders trading against benign corporates and institutions.

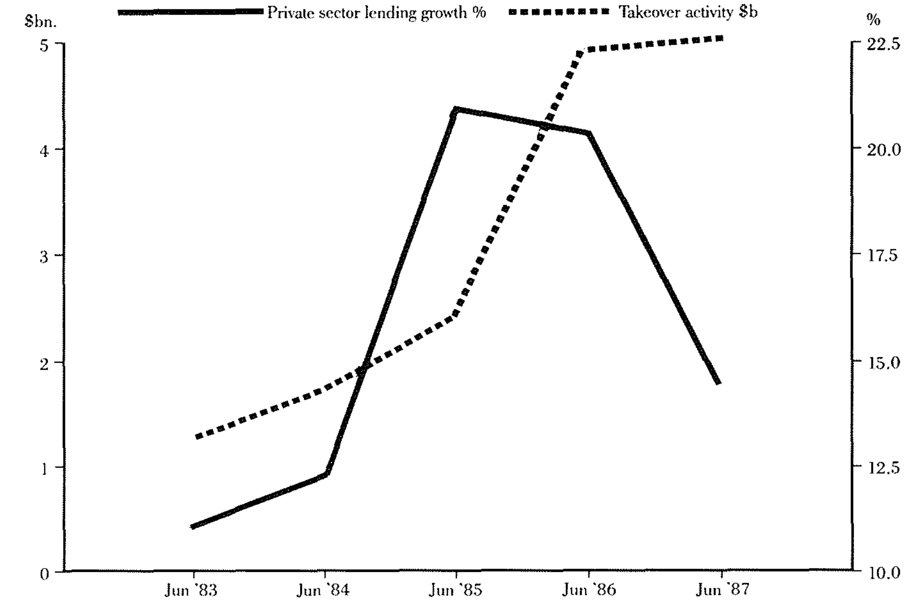
Now pricing of the market has returned to the traditional institutional measure of interest-rate relativities. No longer do prices reflect sell-off potential or the prospect of stockmarket-generated earnings. It's back to basics; that is, real earnings. A bit old fashioned but at least enduring.

The investment institutions' approach to investment decision-making was very similar to that of the entrepreneurs. Not surprisingly, there was a high degree of empathy between the two, as they shared a common benefit from the rising share prices of the bull market.

The growth of superannuation funds in the post-war period, combined with more recent moves by retail investors to use professional management, saw the pool of funds controlled by the investment institutions explode.

Most of the professional investment managers were captives of the short-term performance cult and they provided strong equity support for the entrepreneurial managers. They were, in effect, sub-contracting part of their investment management function to the entrepreneurs who had a more hands-on approach to portfolio management.

GRAPH 5: Takeover activity & private sector lending growth.



The response by poor-performing institutions to criticism of their role in the bull market has tended to emphasise their need to keep high equity weightings for performance-survey reasons. This is really a very feeble excuse for their euphoria. To blame performance measurement is like an athlete blaming the timekeeper because he ran the first half of his race too fast and thus collapsed in the second half. The institutions simply lost sight of the length of the race.

The banking sector was the major funding source for massive expansion of the entrepreneurs' asset base. From 1982 to 1987 the entrepreneurs' assets increased by more than $28 billion which was funded by an increase of $18.9 billion in loans.

At the end of the day, the entrepreneurs came unstuck because they got away from their original objective. . . cleaning up the excesses of the previous boom.

The strong funding support of the banking sector for the entrepreneurs was the result of the heightened competitive environment they faced. The combined forces of financial deregulation and foreign bank entry made the decision to extend credit to an entrepreneurial sector, which was credit-hungry and price-insensitive, a relatively easy one.

The clear fact is that the banks pursued a permissive credit policy with the entrepreneurs. This is demonstrated by the fact that conventionally measured gearing (borrowings/shareholders' funds) increased from a multiple of one at the start of the period to almost two times in mid-1986. In mid-1987 it had reduced to a multiple of 1.5 times and can be expected to return to a multiple of one in the future by forced asset sales (see Graph 4).

Further, it should be noted that conventionally measured gearing ratio understated the group gearing. This is because the entrepreneurs were concerned to maintain controlling shareholdings of their listed vehicles and borrowed from the banks to fund their proportions of the rights issues of the listed company generally on a margin basis. This is a significant component of the credit exposure problem of the banks to the entrepreneurs.

Whilst the institutional portfolio managers have already borne significant sharemarket losses through the demise of the entrepreneurs, the credit losses to be borne by the banking system will also be extensive. The domestic trading banks are well provisioned to cover these losses but foreign-owned merchants will have to call on overseas parent guarantees and/or support.

Given the dominant role of the banks in funding the cycle, it is interesting to ask the question: what drives takeovers — is it value or the availability of credit?

The conclusion of the last cycle is that takeover activity is more a function of permissive credit policies rather than sharemarket value. The value of takeovers increased from $1.2 billion at the start of of the period to more than $5 billion in 1987, notwithstanding the increasingly overheated stockmarket prices. This coincided with a massive expansion in domestic credit availability (see Graph 5).

I believe much was achieved in terms of basic business efficiency. The long period of professional ownership, once it departed from real economic growth, was in need of drastic surgery and the entrepreneurs provided it. Even those businesses untouched by the entrepreneur, but threatened, have adopted some of the entrepreneur's desirable management practices. Now that we have a restored nexus between ownership and control, this process is likely to accelerate.

For the financially sound entrepreneurs, the challenge to further restructure the Australian corporate sector still remains in a more realistic share-price environment. Those entrepreneurs who can add value will survive. However, their profit performance will be very subdued and their gearing levels much more conservative. They will need to manage, add value and move away from paper shuffling.

In the case of the institutional investors, the portfolio managers are now painfully aware of the need for diversification as a discipline in risk-management. To be fully effective this diversification must be global rather than domestic and must be managed from an Australian dollar perspective.

As a result of the need for diversification, the costs of running a portfolio management business will rise. The minimum critical mass of funds under management will need to be above $500 million to break even. Those boutique fund managers who have failed to reach this critical mass are headed for extinction. It is clear that the proliferation of new portfolio managers has come to an end and a significant rationalisation is in order.

Given the dominant role of the banks, it is interesting to ask: what drives takeovers — is it value or the availability of credit?

The write-off of loans by the banks to the entrepreneurial companies and their major shareholders will be substantial. This will result in an overreaction in credit policy by banks. They will move from permissive to excessively conservative. With a marking-time or retreat in globalisation and Australia's relatively diminished importance and credit-rating, international banks will question the financial value of local operations following poor profit results.

No review of the financial landscape would be complete without a comment on the stockbroking industry. This industry participated fully in the excesses of the boom but, given its largely agency role, to lay blame on the industry is like criticising car salesmen for force-selling the overproduction of the car manufacturer.

The competitive pressures released by deregulation in the early part of the period were overwhelmed by the turnover benefits of the bull market. With turnovers down 60-70 per cent, the restructuring of the industry has started and it will finally emerge with enhanced efficiency, profitability and quality.

The bear market presents the financially strong entrepreneurs and motivated corporate managers with the opportunity to continue the vital value-added function of restructuring the Australian corporate sector. As excess capacity is eliminated, we will move into a new investment phase which should be directed towards exports and import replacements.

At the macro-economic level, Australia's problems are those of a commodity-based economy in a deteriorating global environment. We must significantly lift manufactured exports from the current dismal level if we are to overcome a chronic trade deficit and excessive external debt.

This will require close Government attention to the glaring inconsistency of a regulated labour market in a deregulated financial environment. It has always been clear that deregulation of one sector of an economy has an inevitable spread effect to other regulated sectors. This process must happen if Australia is going to adequately adjust to the changed outlook for commodity-based economies in the eighties.

As has been learned in the United Kingdom, the unwinding of the heavy hand of Government via deregulation, privatisation and a reduced call on national resources is a long drawn-out process that takes years to produce results.

In Australia, this process has begun, certainly without the gusto of the UK, and if allowed to continue will ultimately deliver the goods. But it will require patience and a political and economic philosophy that recognises the benefits of a market-based approach. □