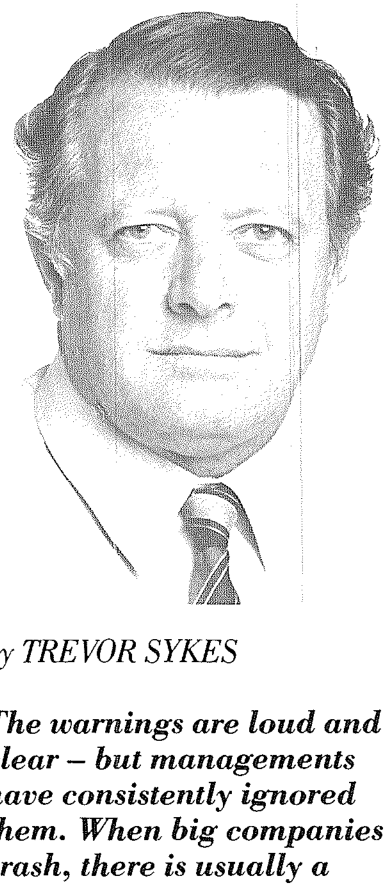
BAD BOSSES – THE BUSINESS BUSTERS

WHEN THE GOING GETS TOUGH, MANAGE!



by *TREVOR SYKES*

The warnings are loud and clear – but managements have consistently ignored them. When big companies crash, there is usually a painfully simple reason.

There is a modern saying that "when the going gets tough, the tough get going". My thesis is that when the going gets tough, the tough can at least survive.

I have recently completed a survey – by no means exhaustive – of the major corporate collapses in Australia's history. It was primarily an exercise in discovering the reasons for corporate collapses, not to gather economic statistics, so I am afraid I cannot offer any mathematical proof of my conclusions, but they are based upon a set of fairly thorough case studies.

Given that some of the conclusions seem obvious, it is remarkable that they have been consistently ignored throughout our history, and sometimes by businessmen running the largest companies of their kind in Australia.

Good businessmen survive.

Whenever an economic crisis occurs, not all companies are equally affected. I am here talking about those businessmen who have survived the truly Darwinistic rigours of small business and have graduated to running at least medium-sized concerns. A small business can go bankrupt through no fault of its owner, but once he or she has expanded beyond that point, I believe economic conditions – while an enormous factor – are not as critical as the quality of management.

My survey concentrated on major collapses. Of the dozens I studied, I found only one innocent victim. That was the Government Savings Bank of New South Wales, which went to its doom in 1931 through no fault of its own, but because it was wantonly sacrificed in a political power play between Jack Lang, NSW Nationalists, Sir Robert Gibson and the Scullin Government – a squalid story from which nobody emerged with credit.

Every other company or bank I studied had in some measure contributed to its own downfall. Some were just corporate accidents waiting to happen, but many were quite fraudulent paper castles.

Let me cite a few examples of good companies surviving. In 1893 we had the largest bank panic in our history. Within a span of six weeks, 13 trading banks closed their doors. Their combined assets at the time accounted for two-thirds of the bank assets in Australia. In the face of this extreme panic, nine banks had conducted their affairs well enough to keep their doors open.

This example is not perfect, because the banks which did not suspend payment were largely saved by an issue of legal tender notes by the Dibbs Government in NSW, but certainly banks such as the Australasia and the Union had seen the storm building years before and had acted to let their risky business go and keep their good accounts. They

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had their sails reefed when the storm arrived and were able to sail through unscathed.

The property collapses of the 1970s were as large and widespread as the land bank collapses of the 1890s, but while some companies went to the wall, others emerged strengthened. Thus Mainline, Cambridge Credit and Parkes and similar companies were all vulnerable to any contraction of credit or a downturn in the property market, while Lend Lease shortened sail well before the boom broke and emerged stronger.

In the 1960s, thanks to 20 years of fixed gold prices, the Australian gold miners were a dying breed.

Some great old companies became virtual shells. Western Mining adapted to changing conditions. It diversified into iron (not terribly successfully), then aluminium. Its heavy investment in research and the fact it was prepared to look at "odd" minerals led it to the discovery of Kambalda, which the company brought on stream quickly to capture the soaring nickel market.

Without this policy of diversification, Western Mining would have remained a struggling gold producer and would have been in no position to exploit so successfully the resurgence of gold in the 1980s. Good management bridged those crucial years.

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Booms kill more companies than recessions.

A company may die during a recession, but the seeds of its destruction are sown during the preceding boom. Bull markets tend to develop lax practices. The incentive to maintain cost control is lowered. Companies embark upon new ventures without submitting them to the full rigours of a feasibility study. Extra debt is raised to fund fast-expanding markets. Buoyed by a few years of burgeoning profits, the management develops an illusion of infallibility.

In a recession, the most vulnerable companies are those that expanded very quickly from a small base during the preceding boom. Our history is littered with examples of this.

Most of these companies suffered very large and sharp contractions almost as soon as conditions turned adverse. As boom babies, they were vulnerable. Conversely, in the 1930s – which must rank as our most severe and prolonged depression – I cannot think of any company which collapsed with the same rapidity. Some went out of business in a slow, grinding fashion, but apart from the Government Savings Bank of NSW there were no dramatic or unexpected collapses. I believe this is because we had no boom of any consequence in the 1920s. Thanks to the dominance of American material in our media, the 1920s have become synonymous with a boom period which met its *Gotterdammerung* in 1929. But there was no corresponding boom in Australia and, consequently, no corresponding bust.

Companies of course must take as much advantage as they can of boom times to get capital and expand. And it is hard to stay prudent while all about you are making apparent fortunes overnight and running past you in the race. But any company that gallops on regardless in boom times will inevitably stumble. So what are the danger signals?

Again, the lessons are fairly obvious, but as they have been ignored so frequently, I feel they bear repeating.

Trading ability. Some people seem to be born traders, with a sixth sense for markets. Those I have met impress me as highly nervous people, in that they are sensitive to every shift in their trading patterns. For the bulk of us, who are not born with such antennae, the best solution would be to follow your basic markets as assiduously as possible. A factor in nearly every business that fails is the lack of a good financial reporting system.

Those whose primary business is trading must always remember that the fact they made a profit yesterday does not guarantee them a profit tomorrow. Nothing replaces eternal vigilance. Gollin was a highly successful trading house for nearly a century, but collapsed after only a couple of years under its last management.

Debt. It is possible for a company to go broke without any debt, but very rare. Most companies that collapse are badly over-geared. Debt, of course, is a very useful source of funds. Few enterprises of any worth would be started without it.

But there is a strong case for paying back borrowings as quickly as possible in boom markets. This may mean that you are contracting operations rather than expanding them in the last year of the boom, but that is precisely when booms are most dangerous.

This applies with particular force to mining companies. Anyone with even a faint knowledge of commodity prices knows that they go down as well as up and I doubt whether there is a mine in Australia that has always operated at a profit. So there are bound to be years when a mine makes losses. It will be able to recover far more quickly if it is not burdened by debt. Dividends can be

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suspended, but interest keeps ticking away.

The late Sir Maurice Mawby of CRA based some of Australia's most successful mines on debt, but the borrowings were raised against sales contracts for the ore. It is, of course, quite sound to borrow money when your income has been guaranteed.

If what I am saying sounds negative, I should point out that booms offer an excellent opportunity to substitute equity for debt.

When profits and share prices are rising, big equity issues can be made, preferably at a premium to keep capital as tight as possible, and substantial debt can be retired. A number of shrewd entrepreneurs did this during the boom of the 1980s.

Debt must be particularly carefully arranged in companies without regular cashflow. The prime example are property and construction companies, where payments normally come in large, periodic lumps. It is essential in any such company that funds should be adequate to meet expenses between payments, that there be a margin of safety and that project deadlines can be met.

Any company that is persistently highly geared is simply laying its head on the block waiting for the guillotine to fall, as happened to Mainline in the Whitlam credit squeeze of 1974.

Finally, any company that is permanently highly geared is robbing itself of its escape zone when times get tough. It simply has nowhere to go for funds when it needs them most.

Credit. Another dangerous aspect of booms is that they tend to lower credit criteria. There are few more sure ways of going broke than by selling goods to customers who cannot and will not pay for them.

Our first major corporate collapse was the Australian Auction Company in the 1840s, which maintained its market share in the hurly-burly of Sydney's early auction scene by extending credit to customers.

This got the stock out of its warehouses, but produced such a pile of bad debts that the company collapsed within a few months of floating.

The same practice was followed by Reid Murray and H. G. Palmer in the 1950s and early 1960s and was the prime reason for their collapse. In one case, Reid Murray sold a refrigerator to someone living in a riverbank humpy outside Albury. In another, it sold more than £700 worth of goods to a destitute Aboriginal.

It is worrying when the board and management of a company do not know about its bad debts.

Reid Murray supported its growing receivables by borrowing from banks and the public. By 1959 its interest-bearing debt had blown out to 2.6 times shareholders' funds, compared with Myer, where debt amounted to only one-quarter of shareholders' funds and David Jones, which had no long debt at all apart from a moderate mortgage.

Bad debts. If you do enough bad business, with customers who cannot afford to repay, your bad debts will surely kill you.

In the majority of collapses, bad debts are a root cause. Several of the companies I have mentioned already were brought down by bad debts, including the Australian Auction Company, H. G. Palmer and Reid Murray. The extent of the bad debts in all these companies was made public only after they collapsed.

Sometimes bad debts mask a scandal. The Queensland National Bank was very friendly with the Premier of Queensland, Sir Thomas McIlwraith, who gave it all his government's business. In return, the bank allowed Sir Thomas, who was a chronic speculator, to run up an overdraft of a quarter of a million dollars by 1893, according to Professor Geoffrey Blainey in *Gold and Paper.*

This is fraud, but at least the players know what they are doing, however criminal. In a sense, it is more worrying when the board and management of a company do not know about its bad debts.

The Commercial Bank of South Australia drifted into a position in 1886 where its largest single account was a gigantic bad debt apparently incurred without half of the board realising what had happened.

Although the property boom broke in 1974, Finance Corporation of Australia does not appear to have calculated the market value of its properties until 1979. As it was the joint venture financier with several of the more hairy property operators of the day, this is exceedingly difficult to understand.

Accounting systems. From these examples, it follows that accurate and prompt financial systems are essential to good management. If you do not have an accurate and current measurement of how your company is performing, then you are not managing it very well and you are in deep peril.

Good financial reporting systems enable entrepreneurs to detect early warning signals that something is wrong with their business.

But of course, the systems must be measuring the right things. I can remember Reg Shanahan, when chief executive of Associated Securities, showing me with pride his weekly financial reporting systems. If a car dealer was having trouble with his floor plan in Brisbane, it would show up in a week or two on Reg's sheets. Unfortunately, what he was not measuring was ASL's increasing exposure to property, which eventually broke it.

Some companies are so bereft of basic information that it is hard to determine how they could have reached the figures in their accounts.

The receiver to the Palmer group calculated that it had not made a genuine profit in the 15 years it had been publicly listed.

The Queensland Permanent Building Society fouled up its computerisation so badly in 1974 that after a subsequent investigation, Touche Ross reported that it ". . did not have effective control over their computer system. The turmoil that existed in the accounting and recording areas proved fertile grounds for errors." Many key records were simply missing. Somehow the board had not known about the mess until 1976.

My favourite example is the Permanent and Equitable Building Society,

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BOOK REVIEW

The Structural Response of Financial Intermediaries to Deregulation – A Balance Sheet Approach.

By Joan Linklater

Reserve Bank of Australia, Occasional Paper No. 11, September 1989, $2.00

Reviewed by WARREN HOGAN

This concise paper offers an effective appraisal of the remarkable changes experienced during the 1980s in the financial services sector. Its purpose is to show how the various groups of intermediaries in this sector have adapted to a massive change in institutional and market conditions. The technique for the analysis is the study of structural movements in the balance sheets of the participating intermediaries.

The topic and the treatment could all too easily seem dull and unrewarding. That impression would be quite wrong. The author explains the performance of these groups of intermediaries in challenging ways, probably a reflection of the author's wide experience in the financial services sector.

Initially the author provides an overview of how the structures of assets and liabilities have changed during the decade. The second chapter examines changes in balance-sheet structure. This is followed by a treatment of trading markets; this means foreign exchange and bonds. Then Chapter 4 turns to off-balance-sheet activities – though the coverage is a bit brief and may be extended by referring to an article on the topic in the Reserve Bank Bulletin for January 1990. Chapter 5 analyses profitability. Interpretations of events are placed in the concluding chapter.

What the author has achieved in such a limited space is a precise appraisal of where the various types of financial intermediary, and the main instruments used, fit into the patterns of financial development. This approach is most helpful. By avoiding a turgid repetition of experiences with each type of intermediary, the paper offers the reader a sharp focus on main points. Should this be considered a "potted" approach, then let the technique pervade more writing on financial matters.

One criticism would be the treatment of profitability. The financial sector glories in the variety of interpretations of accounting standards. It would have been more helpful had there been a greater effort to reconcile some of the "estimates" which are reported as net operating profit. All the more so as the Reserve Bank is thought to favour transparency in balance-sheet valuations. Perhaps this weakness is no more than a commentary on the still-wide gap between official pronouncements and accepted reporting.

This relatively brief occasional paper is strongly recommended. Students of monetary and financial phenomena could not have a better summary statement of structure and interdependence. Experienced hands, especially those no longer sure of their standing as Masters or Mistresses of the Universe, may find much to think about. Mere mortals from the industrial and commercial world should find this a useful guide to the financial services sector, however much they may think "service" a peculiarly twisted term to attach to matters financial. Humble practitioners of retail banking may be well reinforced in their questioning of the "wholesale crowd".

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COMPANY CRASHES

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which collapsed in South Australia in 1885. Investigations revealed it had no deed-book containing particulars of the properties on which the society's loans had been secured. There was no insurance book and no entries had been made in the loan application book for five years. During all this time, incidentally, the society's auditors had been passing the accounts as true and fair.

Remember your goals. If a company has only sufficient funds to achieve one goal, it is potentially lethal to try to achieve a second until the first is secured. Any company which does not observe this commonsense maxim runs the risk of being caught with two projects half-completed at a time when it has run out of funds and has no cashflow.

One fairly recent example of what can go wrong is Poseidon, which barely had enough money to start the Windarra nickel mine, but diverted millions to start up a poorly-conceived revival of the Burra copper mine. Poseidon went into receivership in 1976 without ever receiving adequate cashflow.

A truly crazy example was the float of Chevron Sydney, which raised nowhere near enough funds to build its great hotel and in a moment of madness spent nearly all the funds on a string of property speculations.

Kill losers quickly. A company that is losing money in good years can become positively lethal in terms of cash drain if the market turns sour. A good example is Mainline, which had two losers in Glenvill Homes and Noahs. These became real problem areas after the Whitlam credit squeeze hit, which was precisely the time the Mainline management did not need such distractions.

It should be pointed out that size is no protection. A big company may be able to hide its problems for longer than a small business, but if it is being run badly, the size of its problems will make it very difficult to save.

Mineral Securities was the biggest share-trader of its day in Australia. Patrick Partners was the biggest broking house. The Bank of Queensland in 1866 was the government's chosen bank. Reid Murray was one of Australia's largest retailers. The Bank of Adelaide had the largest business in South Australia. All went.

It is perhaps a predictable conclusion to say the evidence is overwhelming that good business is compatible with business survival.

Those entrepreneurs who watch their market closely, who keep their accounts under close scrutiny, who plan their expansions rather than follow a giddy boom into the stratosphere, who use debt sensibly and who prefer genuine paying customers to illusory sales, are the businessmen with the best chance of survival. They are also the businessmen we need. □