



Financial Executives International of Australia

What drives corporate wealth creation?


Review of Australian evidence

Justin Bown
Managing Director
Australia & New Zealand
Stern Stewart & Co.

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[+61 3] 9650 8100

EVA® is a registered trademark of
Stern Stewart & Co.



Stern Stewart & Co. is a valuation focused corporate advisory firm

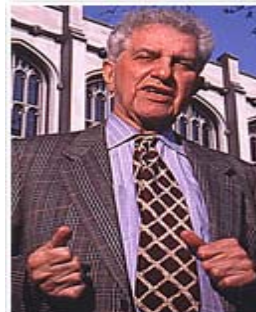
Global leader in value-based management

- 20+ years advising on company valuation & behavioural aspects of management systems
- Local clients include ANZ, Rinker, Mirvac
- 500+ clients worldwide



There is no profit unless you earn the cost of capital. Alfred Marshall said that in 1896, Peter Drucker said that in 1954 and in 1973 and now EVA has systematized this idea, thank God.

***Peter Drucker,
Claremont Graduate School***



You have to account for the cost of capital or you're nowhere. The people at Stern Stewart are very talented at applying M&M to real world situations.

***Noble Prize winning
Financial Economist,
Merton Miller***



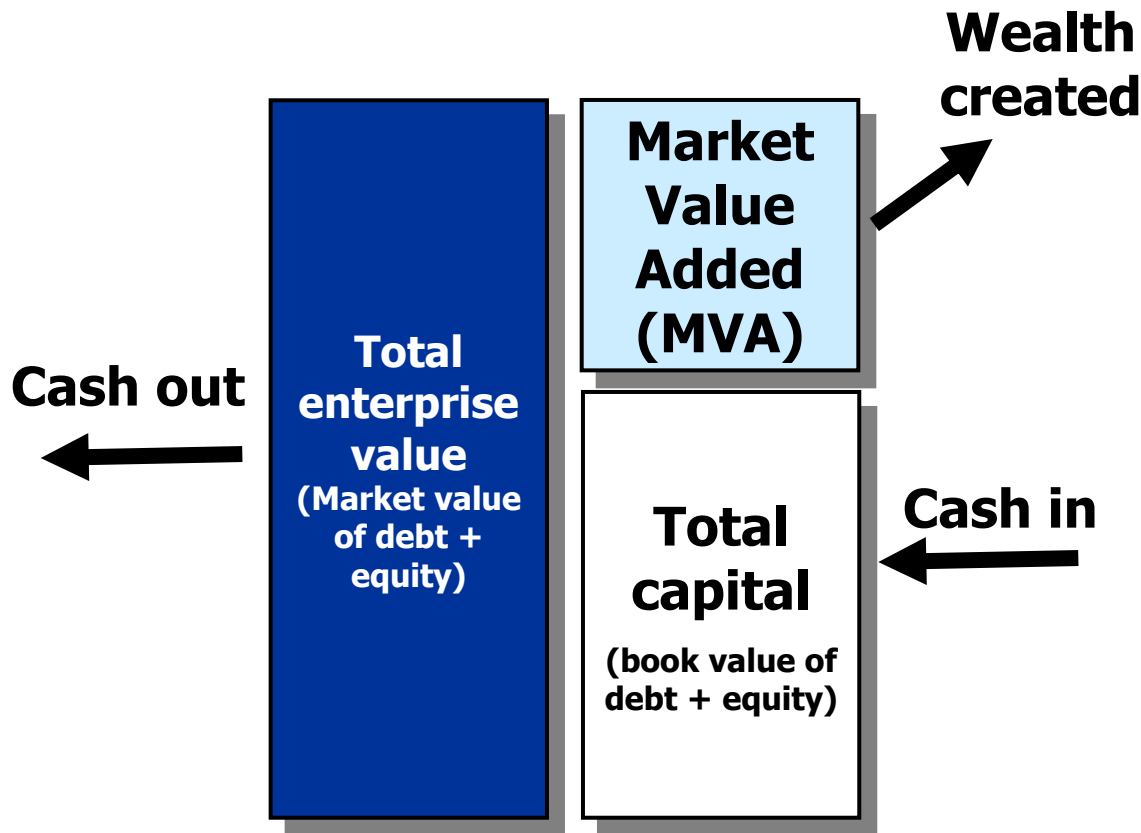
EVA... not only focuses management on creating value for shareholders, but helps investors and managers measure, observe and understand the underlying value drivers or destroyers of a business.

***Salomon Smith Barney EVA
Primer***



Stern Stewart & Co.

The role of the corporation in our society is to create wealth for shareholders



'We feel noble intentions should be checked periodically against results. We test the wisdom of retaining earnings by assessing whether retention, over time, delivers shareholders at least \$1 of market value for each \$1 retained'

Warren Buffett



It is market value, net of capital investment, that matters

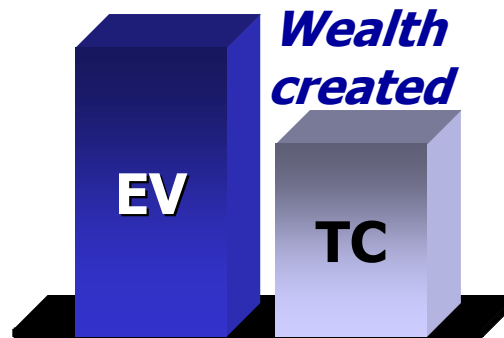
Wealth is created when funds are invested for good returns

Generate returns equal to those required for risk...



...trade at book value

Generate returns above those required for risk...



...trade above book value

Generate returns below those required for risk...



...trade below book value

Leaving the question of price aside, the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return. The worst business to own is one that must, or *will*, do the opposite – that is, consistently employ ever-greater amounts of capital at very low rates of return.

Warren Buffett, letter to shareholders, 1992



EV = enterprise value
TC = total capital

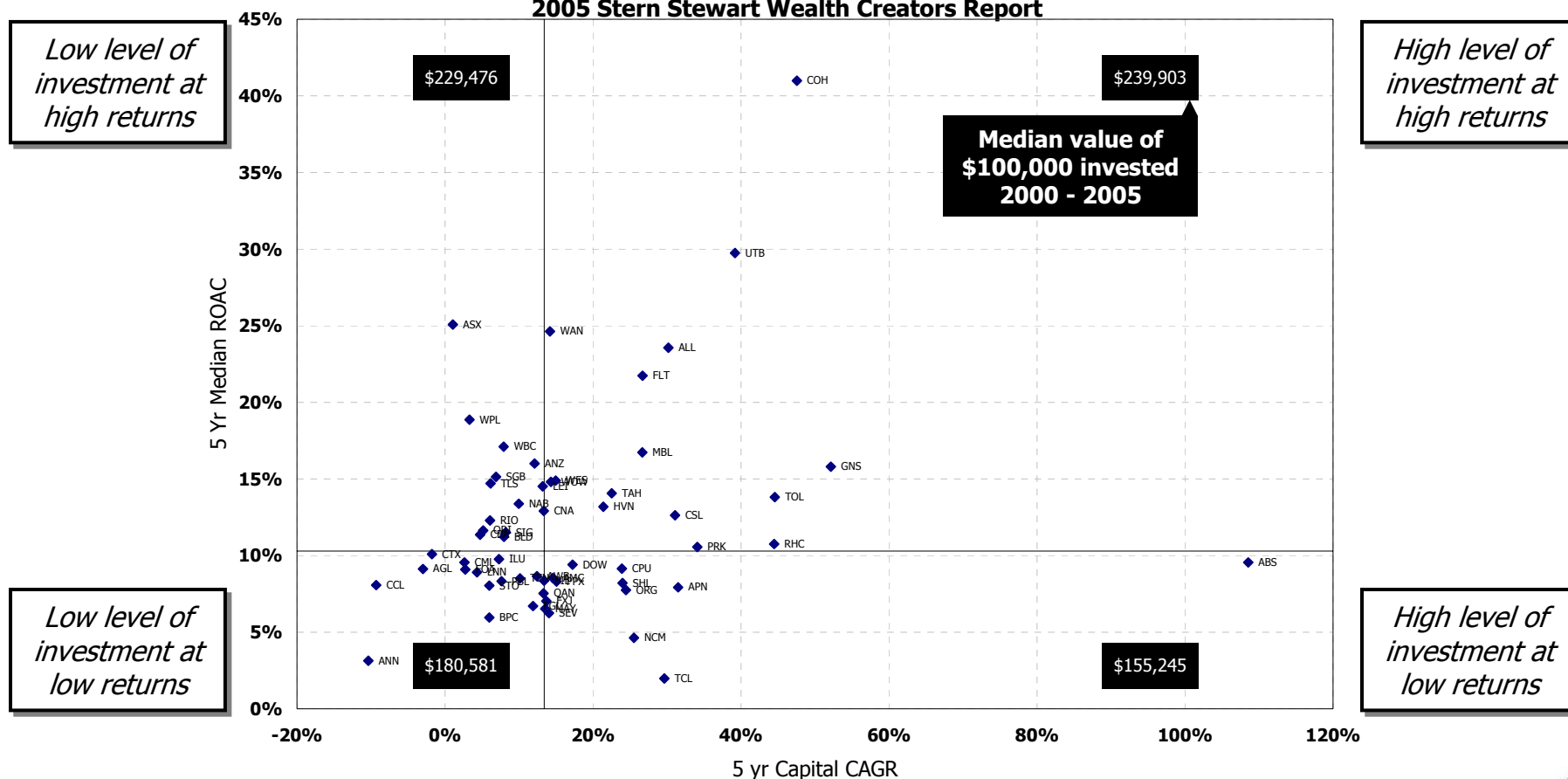


Buffett's insights play out in practice among Australia's largest companies

5 year Total Return to Investors by Return on Funds Invested and Growth in Funds Invested

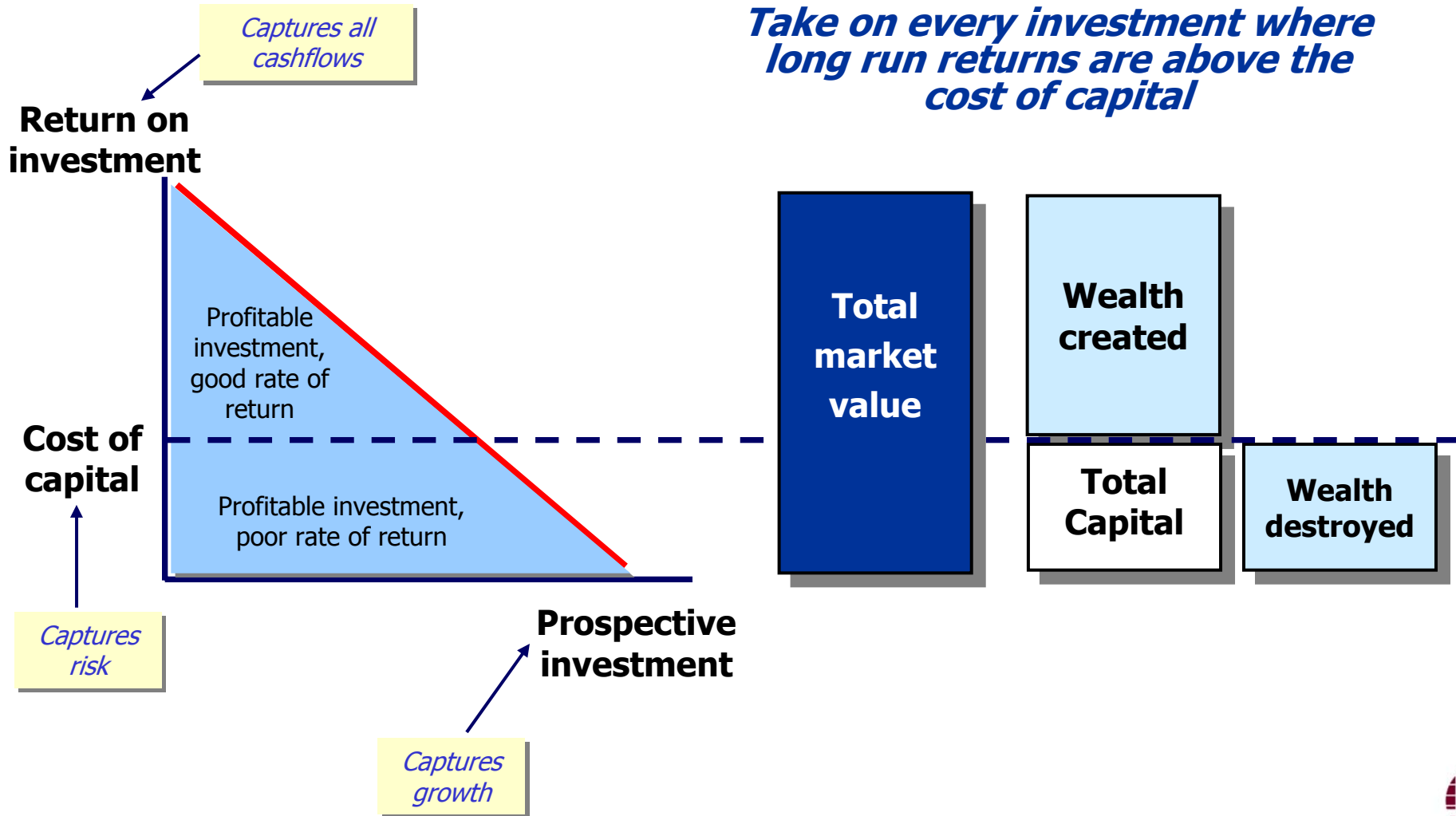
n = 58

2005 Stern Stewart Wealth Creators Report



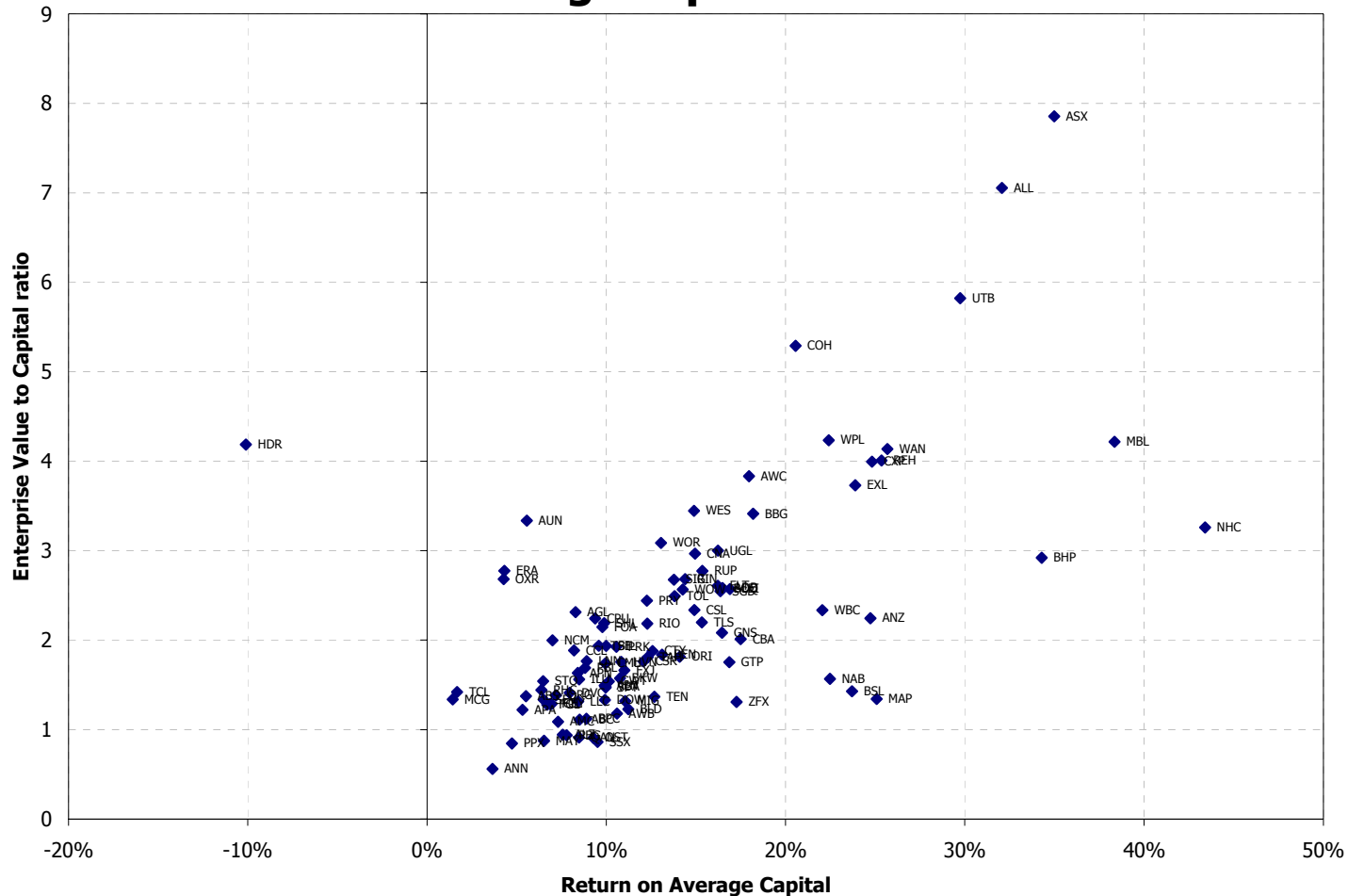
What matters then in creating wealth is investing money at good rates of return

Take on every investment where long run returns are above the cost of capital



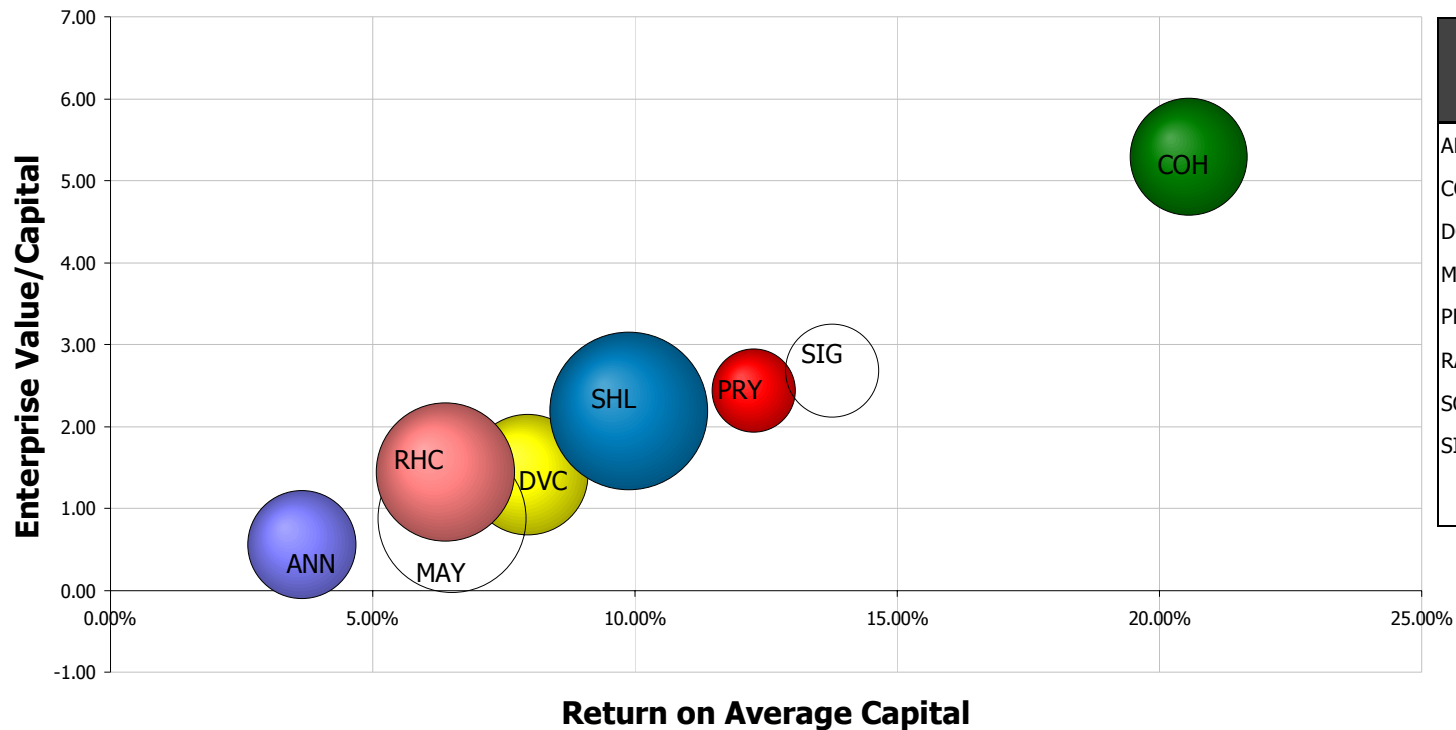
Long run returns drive the premium that companies in the top 100 enjoy over book value

2005 Wealth Creators Report Return on average capital vs. market to book



The relationship also holds at the industry level...

Health care equipment & services Industry returns on capital 2005 Wealth Creators Report



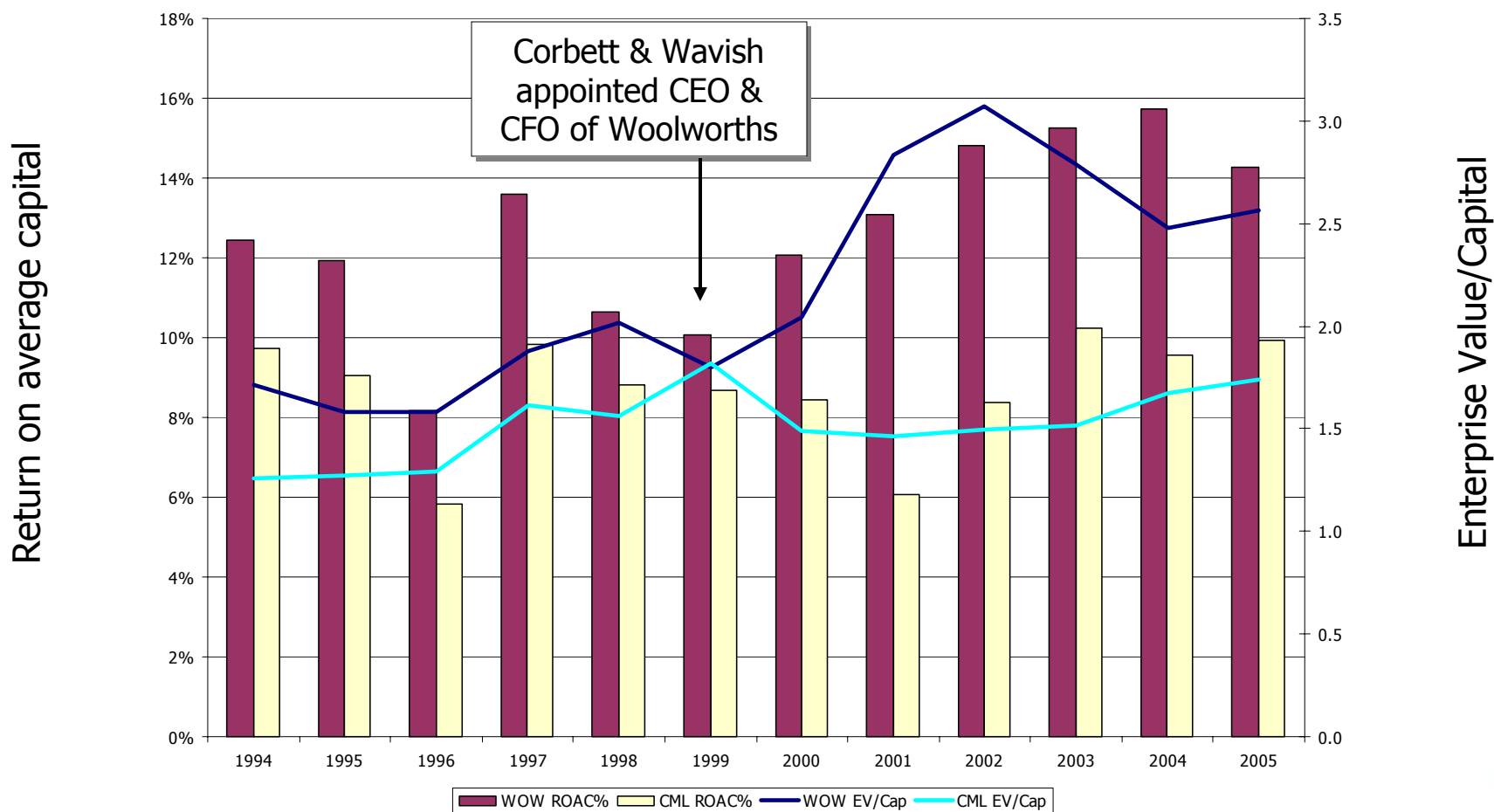
Company	Ticker
ANSELL LIMITED	ANN
COCHLEAR LIMITED	COH
DCA GROUP LIMITED	DVC
MAYNE GROUP LIMITED	MAY
PRIMARY HEALTH CARE	PRY
RAMSAY HEALTH CARE	RHC
SONIC HEALTHCARE	SHL
SIGMA COMPANY	SIG

Bubble size indicates relative Market Value for each company

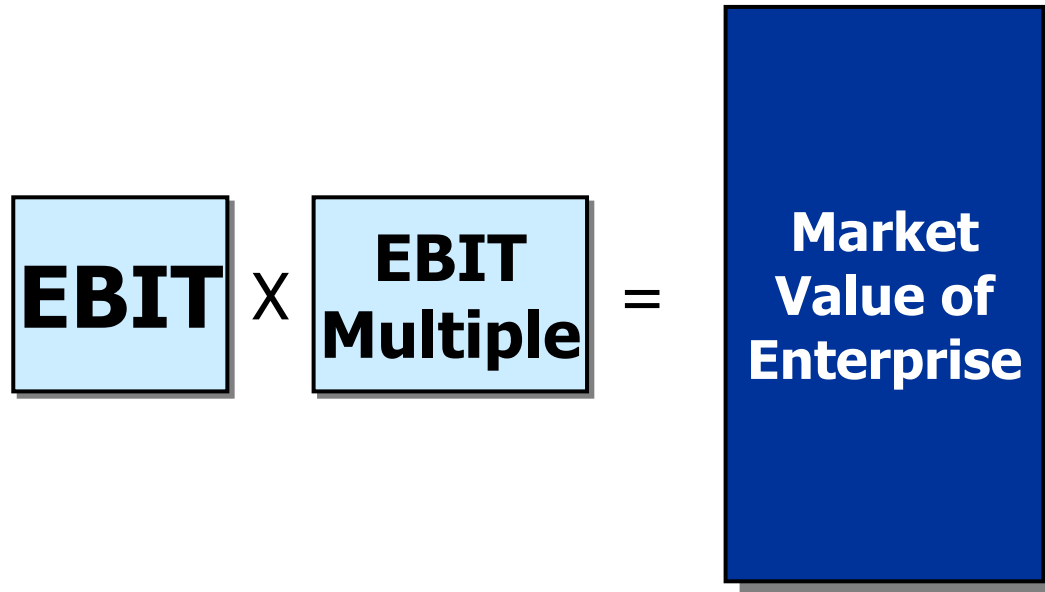


...and amongst competitors

Woolworths vs. Coles Myer Historical returns and valuation premium



How does this reconcile to an earnings multiple approach to valuation?



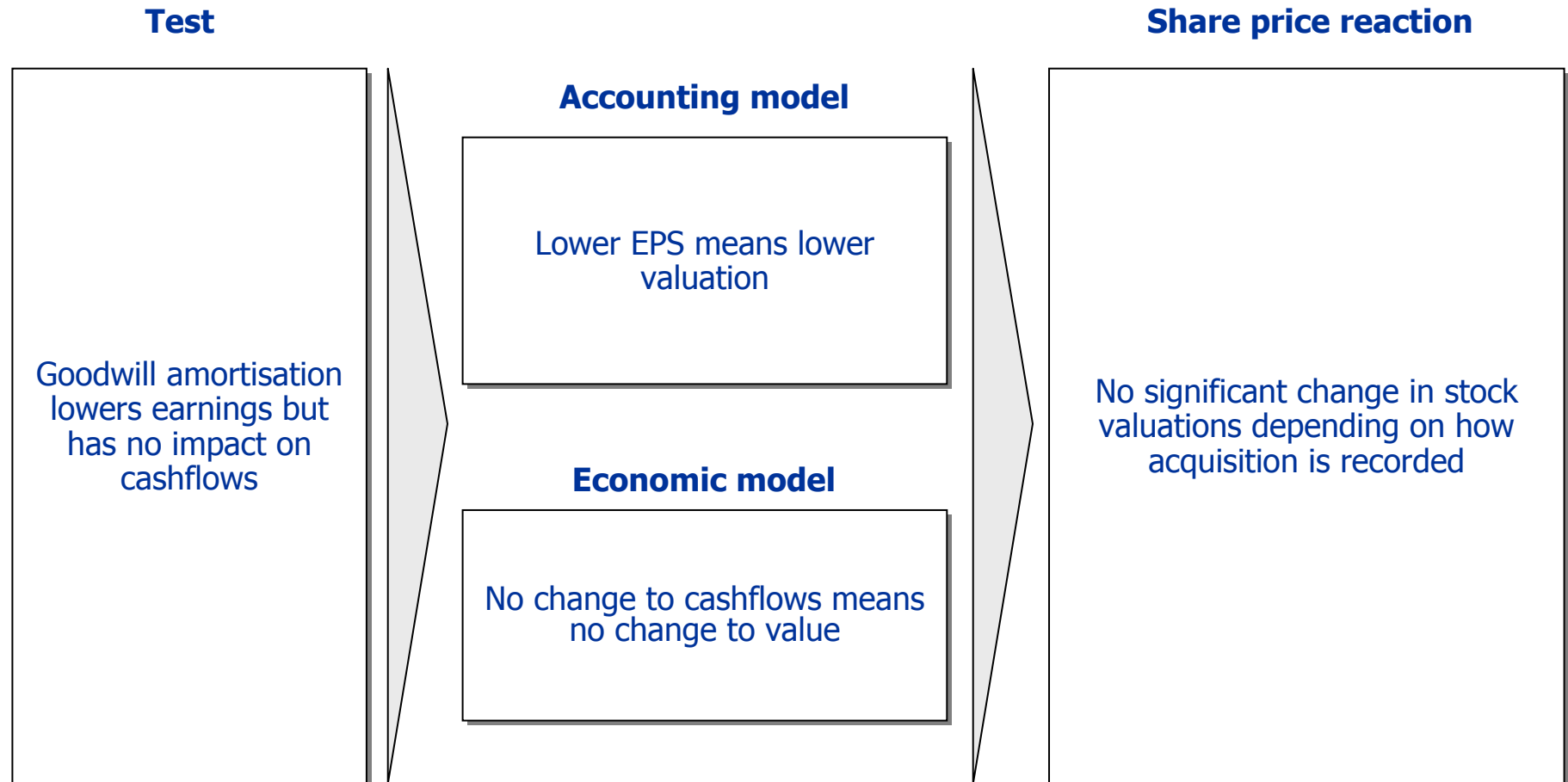
- Simple
- Readily observable
- Objective

BUT, the EBIT multiple has to capture all the missing elements of valuation:

- Capital requirements
- Sustainability of returns
- Growth
- Risk

<u>Year</u>	<u>EBIT</u>	<u>Industry EBIT Multiple</u>	<u>Enterprise value</u>
2006	\$20m	10	\$200m
2007	\$10m	10	\$100m

The multiples approach also suffers from a reliance on accounting earnings



See for example: Hong, H., R. S. Kaplan, and G. Mandelker. 'Pooling Vs. Purchase: The Effects of Accounting for Mergers on Stock Prices,' Accounting Review, vol. 53 (January 1978), pp. 31– 47.

P/E is not the cause of stock price, but the consequence

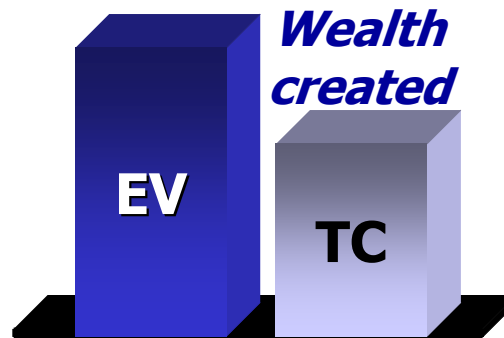
Recall, wealth is created when funds are invested for good returns

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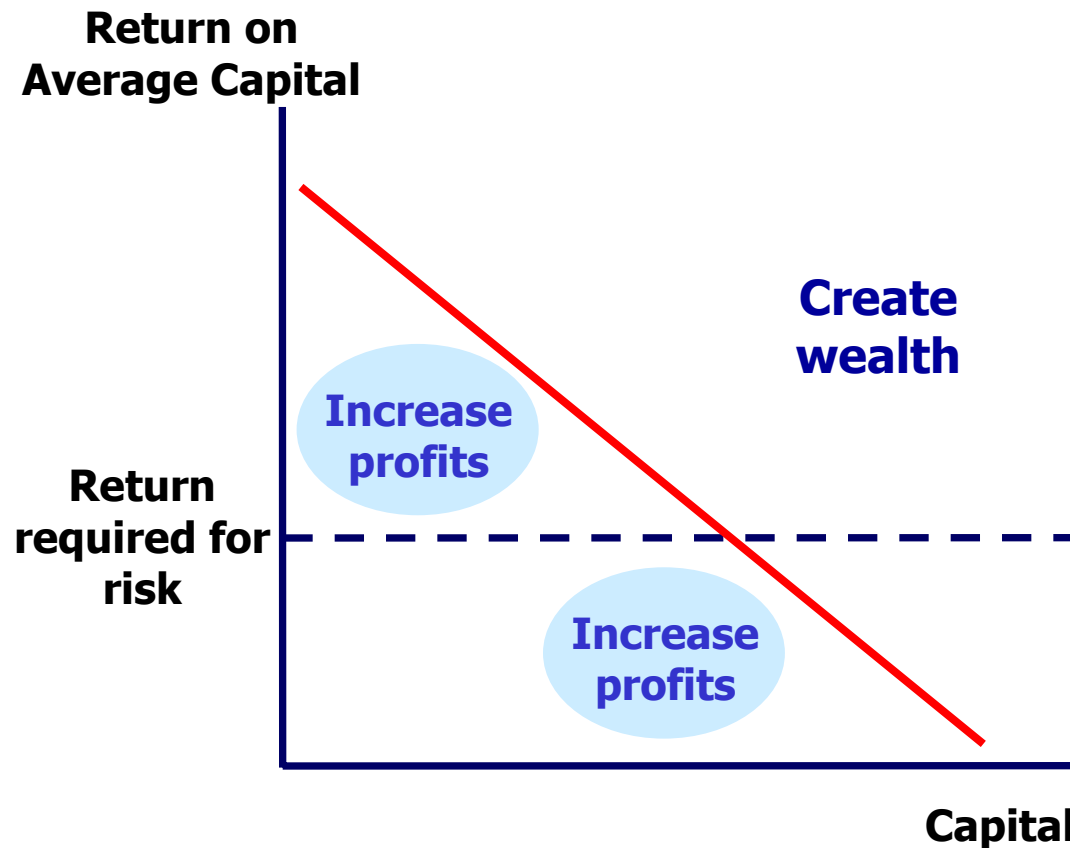


But the accounting framework most businesses follow includes a major trap

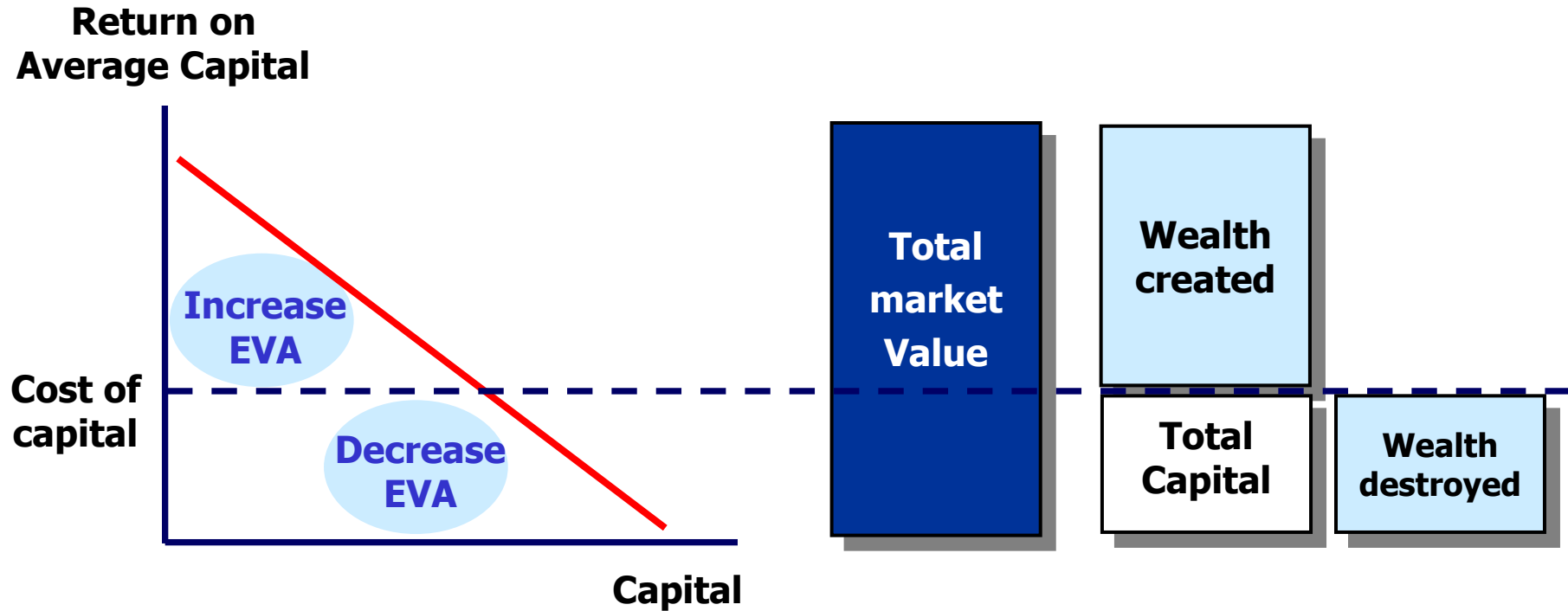
Accounting framework of valuation

$$\text{Value} = \text{EPS} \times \text{P/E multiple}$$

Assumes the P/E multiple remains constant



To rectify, we developed EVA[®]...



Take on all positive NPV investments, or...

Maximise EVA



EVA provides a clearer picture of a business' ability to create wealth for investors



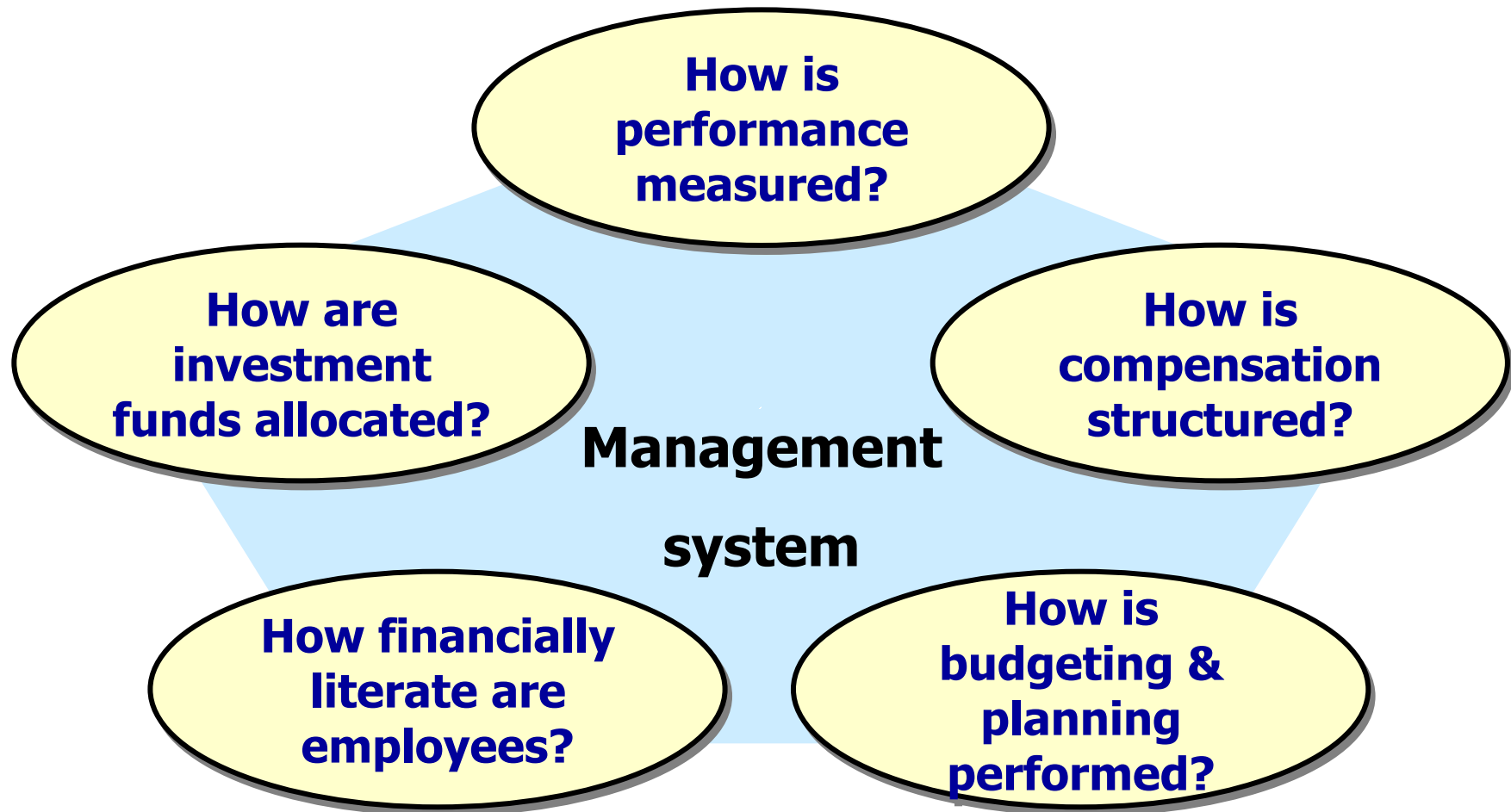
FOSTER'S GROUP EVA ANALYSIS

	<u>2005</u> \$m		<u>2004</u> \$m	<u>2005</u> \$m
Revenue	\$3,972	Debt	\$2,853	\$5,296
<u>Expenses</u>	<u>\$2,607</u>	<u>Equity</u>	<u>\$7,183</u>	<u>\$7,180</u>
EBIT	\$1,365	Total capital	\$10,039	\$12,478
		Average Capital		\$11,258
Return available elsewhere at the same level of risk	<u>\$1,443</u>		@ 13% expected return	
<u>Value gained (lost)</u>	<u>-\$78</u>			

Source: Stern Stewart 2005 Wealth Creators Report

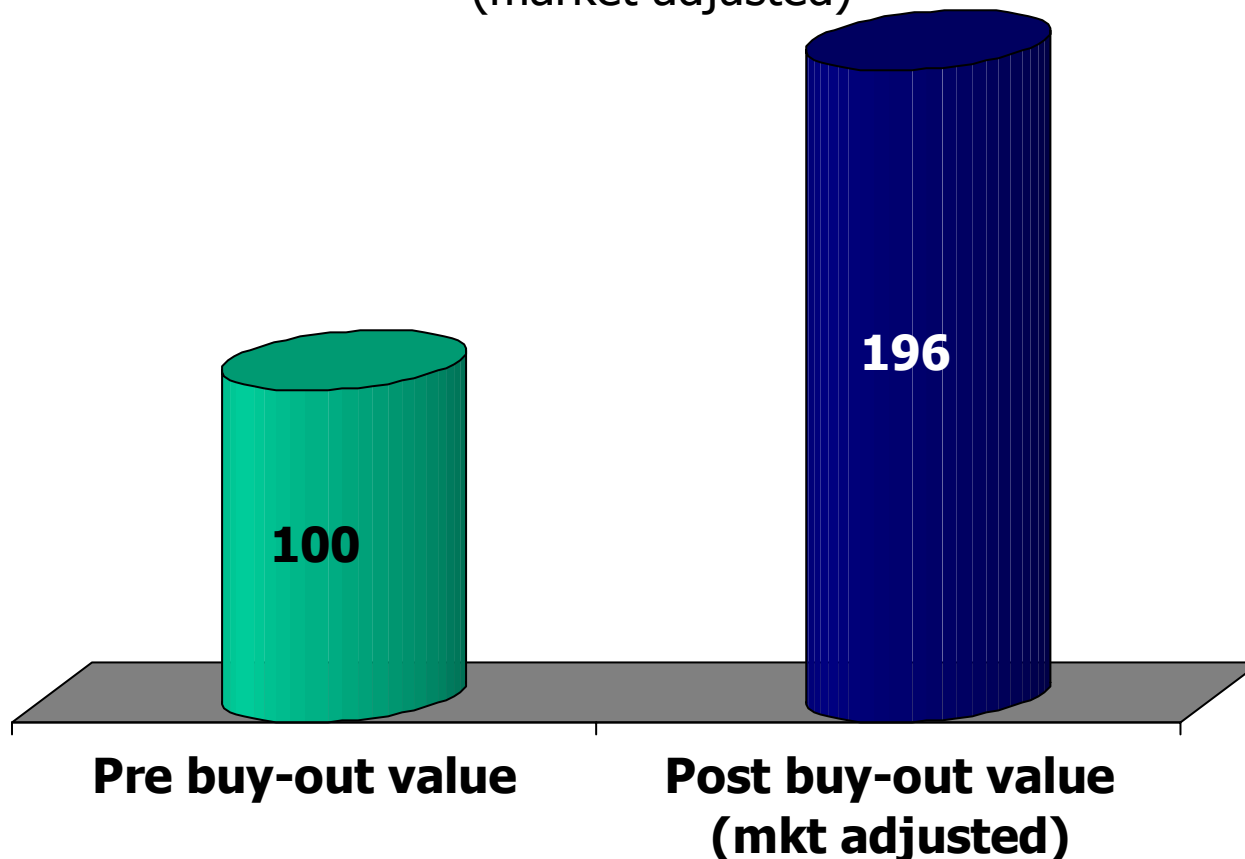


A management system captures the *rules of the game* by which an organisation operates



MBOs represent the most compelling example of management systems as wealth creation strategy

Average increase in the value of a company undergoing a management buy-out (market adjusted)



'LBOs provide a good source of estimates of value gain from changing leverage, payout policies and the control and governance system because, a first approximation, the company has the same managers and the same assets but a different financial policy and control system after the transaction'

Michael C. Jensen
Jesse Isidor Straus Professor of
Business Administration,
Emeritus

Source: Kaplan, S. 1989 'The effects of management buy-outs on operating performance and value.' *Journal of Financial Economics* 24, no. 2, pp. 217-254



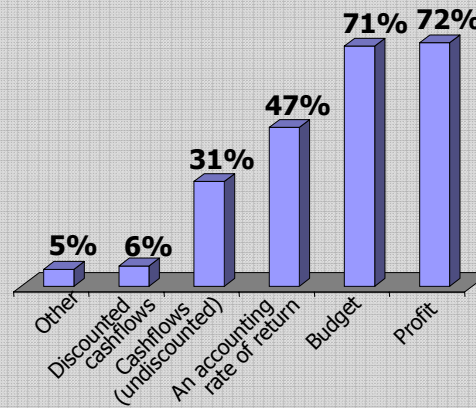
The way performance is measured changes under an MBO...

Over-arching focus

Annual focus

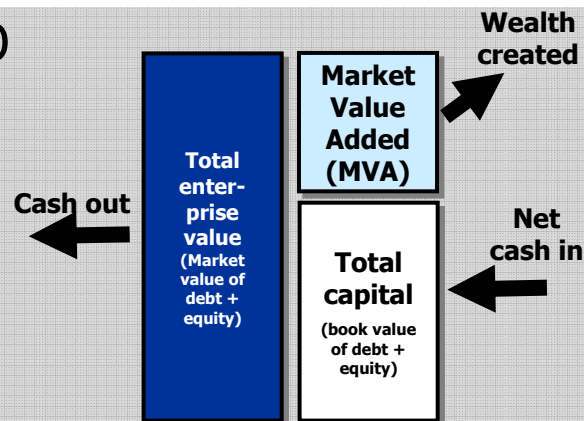
Which means that

Public company



Capital rides for free

MBO



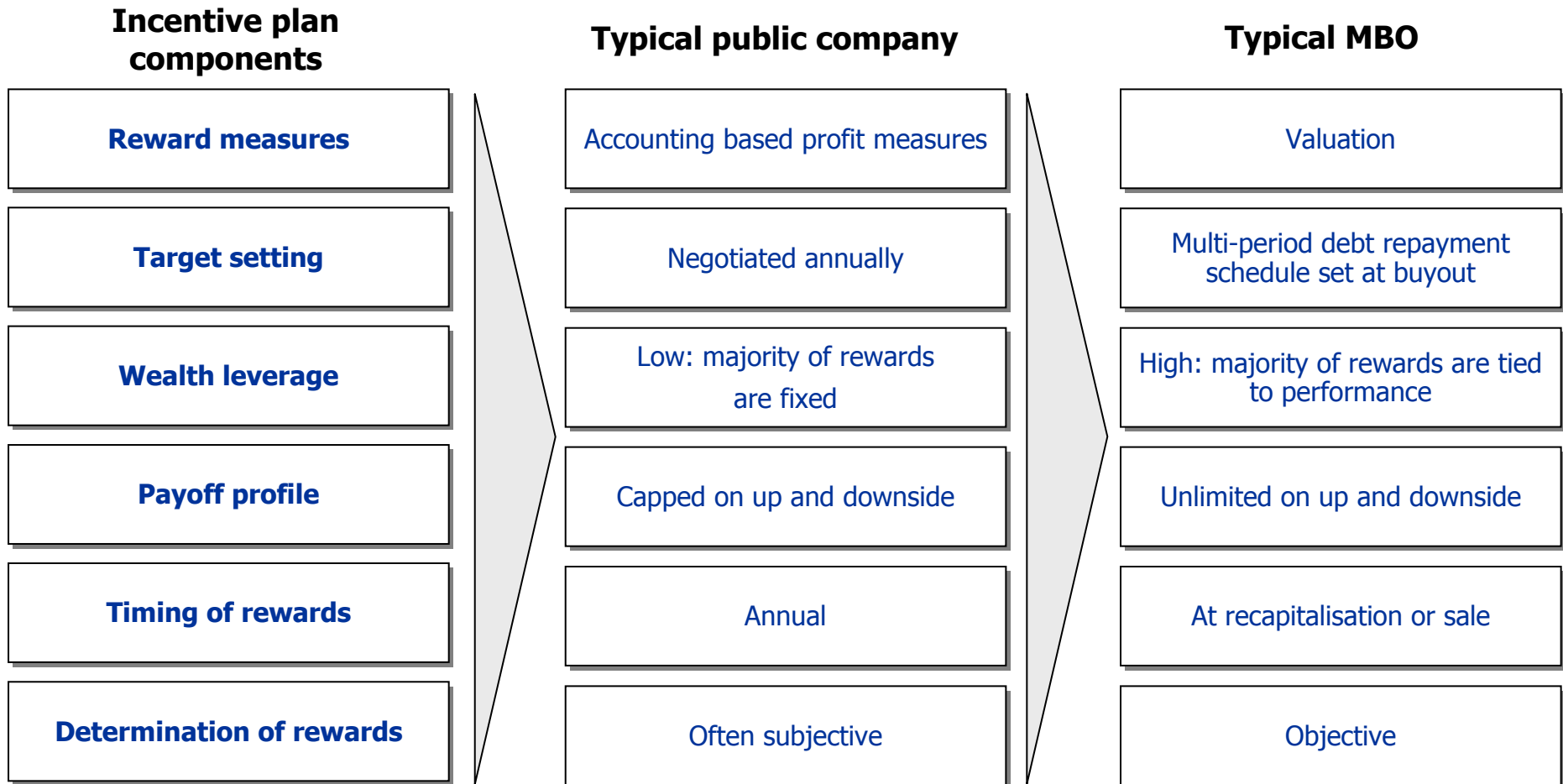
*'There were new rules to the game following a MBO...executives had to learn to focus on unfamiliar measures such as return on market value and free cash flow instead of earnings per share earnings growth and price earnings ratios.'***

Capital has an opportunity cost

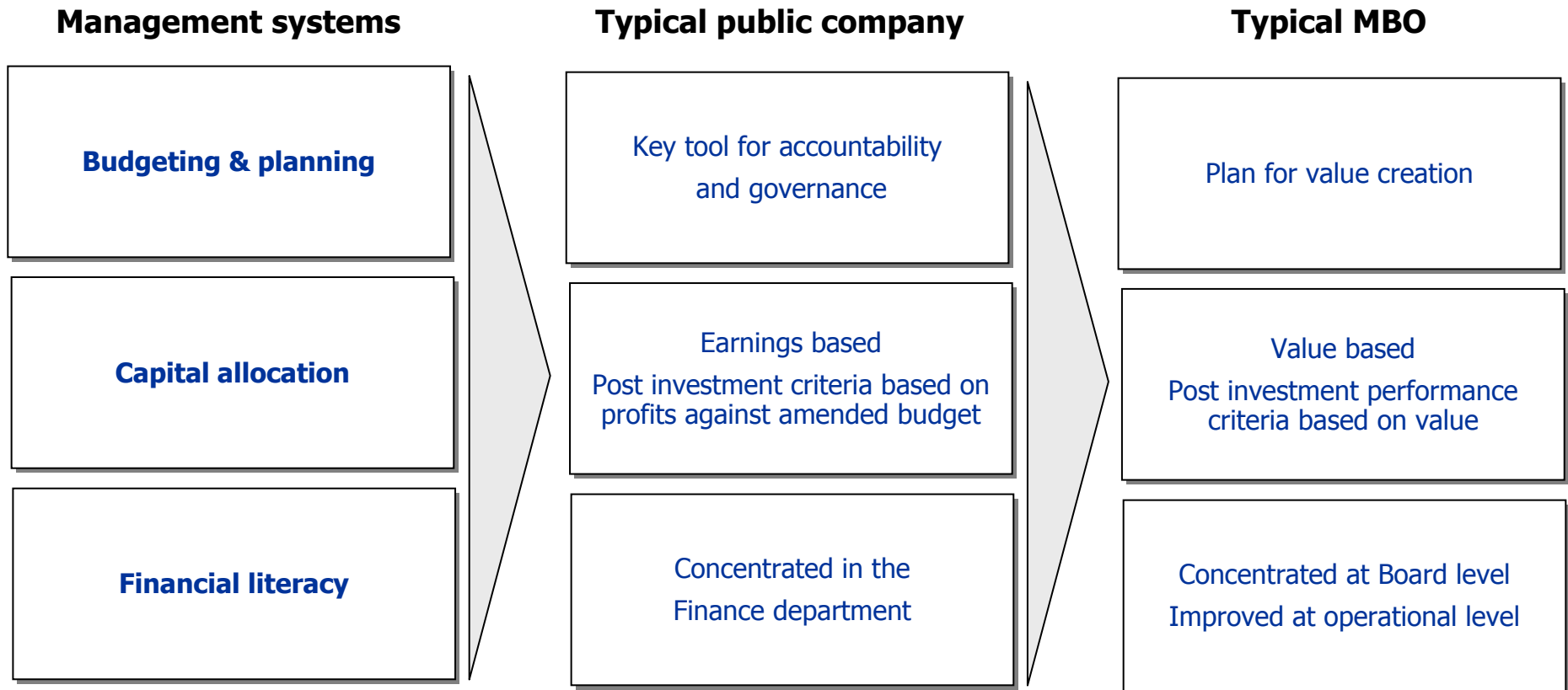
*Source: Arnold, G. & Hatzopoulos, P. 1999 'Ex ante investment appraisal methods and ex post performance assessment comparison and the calculation of the cost of capital' in UK firms' *Aston Business School Research Institute*

**Source: Baker, G. & Smith, G. 1998 'The New Financial Capitalists: KKR and the creation of corporate value' *Cambridge University Press*, p. 98
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...as do the incentive structures...



...and other key elements of the management system



Some public companies recognise the benefit of 'management systems'



Berkshire Hathaway

S&P 500



Wesfarmers

ASX 300



Wesfarmers' disciplined financial management has been the key to its success

	Typical public company	Wesfarmers ¹
Performance measures	Accounting based profit measures	<p>'There is no confusion about objectives at Wesfarmers. Goals are expressed in purely financial terms – to provide a satisfactory return to shareholders. This is measured in TSR..."satisfactory" is defined as being in the top quartile of TSR.'</p> <p>'With the managers of all its business units working to one clear and unambiguous objective, each has to provide return on capital (ROC) of 18%.'</p>
Incentive compensation	Low wealth leverage, based on accounting profits v. budget, capped, often subjective	<p>For divisional managers, based on annual profit and ROC targets.</p> <p>For the MD, over the past 10 years, based on pre-agreed share of ROE & shareholder's equity, paid into a pool and then accessed over time. More recently capped to ensure not exceeding 'levels beyond that originally envisaged for excellent performance.'</p>
Budgeting & planning	Key tool for accountability and governance	ROC targets known in advance.
Capital allocation	Earnings based Post investment performance criteria based on profits against amended budget	'Any unit with more than 18% ROC is told to go and find new growth opportunities and, if the figures add up, it will get the capital. Businesses with 10-18% are told to produce five-year plans showing how they will get to 18%. Those with less than 10% are asked to show how they will get to 10% quickly, or they will face the consequences of the "ultimate capital reduction."'
Financial literacy	Concentrated in the Finance department	'This is another area in which Wesfarmers differs from other companies. It has put together a large team of analysts, mainly MBAs, who spend their time analysing opportunities, helping divisions with commercial issues, working on new projects and negotiating contracts.'

¹ Source: Wesfarmers 2003 Annual report; Gettler, L. Oct 2002 *Management Today*
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Discussion

