WHAT TO LOOK FOR IN SUCCESSFUL COMPANIES

Good morning ladies and gentlemen and welcome to my talk on "what to look for in a successful company". On the face of it this should be a straightforward topic. However, quite a number of questions go begging.

But before I begin please let me make it clear that nothing I say about any company should be taken as a recommendation. Any references that I make to any company will be purely to illustrate a point or to provide an example and will not necessarily represent my view about that company or its investment merits.

Firstly, as sharemarket investors do we really care whether or not a company is successful.

Secondly, by what standards do we judge success and

Thirdly, as outsiders are there even any reliable signals that point to success.

Lets have a go at the first point; do we care whether or not a company is successful. What we are interested in is successful stocks. Day traders certainly don't care they are looking for a quick trade, a speculative return. They live on rumour and gossip and dare I say inside information. Technical analysts in their pure form would prefer not even to know what any given company does let alone how they perform in financial terms; all they need to know is in the charts. What they look for are patterns in share prices and the balance between demand and supply of stock.

History would seem to indicate that in the short term there is little correlation between the success of a company, whatever that may mean, and successful sharemarket performance. Just look at any number of booms and subsequent busts over the past 30 years to see who were the high flyers and who were the survivors.

Does anyone remember Poseidon, Central Pacific Minerals and Southern Pacific Petroleum, together the Shale Oil Twins, or Sausage Software.

Small exploration companies have historically populated the penny dreadful end of the market where the speculators lived. Today they are joined by a large number of tech and biotech wannabes. Success, in terms that we would understand is something they might dream about. But that does not stop the punters nor the sometimes huge volatility in their share prices.

If we look more closely at the Tech boom, the driving force was the expectation of great riches that would flow from massive investment in infrastructure that was to feed an enormous surge in demand. Does that sound familiar? It was exactly the same force that drove the resources boom in the early 1980’s and the nickel boom before that. Inevitably these booms fail to live up to their expectations as demand fails to grow and be sustained at anticipated rates whilst excessive investment results in overcapacity and excess competition. Share prices are driven by expectations and those expectations don’t necessarily have to be supported, at least in the short term, by prima facie evidence that they are achievable.

To use a cliche, the great driving forces of the sharemarket are greed and fear. In a rising market, greed is in the ascendancy and all too often sharemarket success has more to do with hope and wishful thinking than a well executed business plan and strategy.

Nonetheless, over the longer term the market is rational and it ultimately recognises and rewards successful companies.

Indeed, companies that have a record of above average earnings growth, for example, will often be rewarded with a premium valuation. However, the problem is that often it takes quite some time for success to be recognised and given the reward that is deserved.

So if you are serious about sharemarket investment, rather than trading, it is important to understand what to look for in a successful company. The message here is that successful investment in the sharemarket requires patience and a long term view.

If you'll forgive me, this is the part where I do some preaching. My rules for any sensible investor are:

Understand yourself and in particular understand how much risk you can bear. This will reflect your individual psychology, income needs and financial constraints. A retiree living on investment income will have a completely different risk profile from a young professional on a high income.

Have clear objectives. This is about understanding why you are invested in the market in the first place and what you hope to achieve and over what time frame. Simply, to make money is not an objective. A target total return of say 15 % per cent per annum is an objective, having enough cash income to meet a retirees income needs is an objective. The objectives must also be achievable in the context of current interest rates, the outlook for the sharemarket and your risk profile. In particular, there is no point having aggressive objectives if you can't stomach the risk.

Have an investment strategy built around a diversified portfolio with stocks in a variety of industries and sectors. This is about risk management. It doesn't matter how much research and analysis you do, something will happen out of left field that will have an unexpected impact on the performance of one or more stocks in your portfolio. Having a diversified portfolio mitigates this risk.

Have a strategy for holding each stock for three to five years although subject to regular review and fine-tuning if necessary. As I said earlier, it is only over the longer term that the sharemarket properly rewards successful companies. Indeed sometimes it takes a number of years for a company to achieve success for a new strategy. However, things go wrong and sometimes stocks don't and are not likely to meet our expectations. When that happens you must be prepared to sell and move on.

The second and probably hardest question to answer is by what standards do we measure success. The problem here is that success is very much like beauty in that it lies in the eyes of the beholder. It very much depends on what we are looking for.

Many companies today judge their success in terms of annual TSR or total shareholder return. This includes dividends and capital growth. One of the problems of this is that management can only directly control dividends; it is the market that will deliver capital growth. The other problem of course is the short time frame that management typically views. As a result management's views of TSR tend to be self-serving.

The great argument in support of option schemes that everyone enthusiastically welcomed during the 90s was that they would align the interests of management and staff with those of shareholders. Not only was this proven to be a lie, it actually pitted management against shareholders because it exaggerated the different objectives of these two groups. As much as anything else, this was due to the fact that most shareholders had paid money for their shares whilst management options in effect had a zero, or near zero cost for the beneficiaries. Accordingly, the risk profile of these two groups was completely different. This should come as no surprise when one group has significant downside in terms of the capital they have outlaid as against another group, which has no downside because they had not outlaid any money. The result was that many company's pursued aggressive short-term strategies with the principal objective of boosting their share price. This was at the expense of their longer term strategies and performance.

I don't think that there are any universal standards for success. Obviously, long-term value creation for shareholders is the objective but what is the benchmark? Rather I think that investors have to set their own standards and benchmarks based on their own objectives. If you have an objective of a high yield with relatively little risk your measure of a successful company will differ from someone looking for strong earnings growth, which will be different again from someone looking for technology development or someone invested in an explorer.

Nonetheless, I think that certain companies will stand out and be generally acknowledged as being successful, regardless of our own objectives. This would probably reflect a long period of sustained profit growth and share price appreciation. I guess you would include Woolworths, Westfield Holdings, Wesfarmers, QBE and Flight Centre in this group.

The next obvious question is whether these companies have been successful investments. No doubt for some investors or even many they have been very successful. But this may not necessarily be the case. Indeed the happiest investors will almost certainly be those who have held their shares the longest. Investors who have only recently acquired their shares may be disappointed, if the share price has fallen. This again proves the value of long term investment.

Most companies, however, have their ups and downs. They will have periods of success and periods of disappointment, if not failure. Amcor, BHP, Brambles, Foster's, Mayne, Westpac, Qantas, Lend Lease and James Hardie are perfect examples.

I made the point that if we decide that a stock in our portfolio is failing to meet expectations and unlikely to do so, it should be removed. Can we reconcile this with the knowledge that most companies perform in cycles with periods of success and periods of disappointment? I think we can and further I think we can develop an investment strategy where we can use our knowledge about market psychology and what to look for in a successful company.

Yes, as long-term investors we are principally attracted to successful companies. However, what we need to be on the look out for are change points, companies that are either moving into the successful category or out of that category. Because most investors build their expectations by extrapolating the past, they largely miss the turns and usually the big moves, up or down, in the share price.

Probably the two most common stock picking strategies using fundamental analysis are value and growth. A value-based strategy is looking for stocks that are significantly underpriced relative to their growth prospects and cash generating capabilities. A growth-based strategy is looking for stocks with earnings prospects considerably higher than the overall market. Both strategies are underpinned by the expectation that the companies have structures and systems in place that will deliver long-term success. A key to each of these strategies is picking the turning points.

Turning points are exceptionally difficult to identify and most investors will only see them well after the fact. Investors instantly react to news, good or bad, however, the challenge is to separate the noise from what is important and to differentiate short term issues of little consequence from fundamental issues that point to major changes in trends and outlook. We will come back to this point later.

Nearly 10 years ago two Stanford University academics undertook some research into what makes companies successful. James Collins and Jerry Porras published their findings in a fascinating book called Built to Last, Successful Habits of Visionary Companies.

To quote them, “We chose the term visionary companies rather than just successful or enduring companies to reflect the fact that they have distinguished themselves as a very special and elite breed of institutions. They are more than successful. They are more than enduring. In most cases, they are the best of the best in their industries, and have been that way for decades.” They also note, however, that these companies are not perfect and they don’t have unblemished records. Clearly, they have some intrinsic feature that allows them to bounce back and resume their mantle.”

Their analysis showed that the visionary companies in their research over the long term outperformed by a very large margin a comparison group of companies that were in the same industries. And they outperformed by an even larger amount the overall market.

Their visionary companies included 3M, American Express, Ford, Hewlett-Packard, IBM, Nordstrom, Sony, Wal-Mart and Walt Disney amongst others. Most of those names are iconic and would be familiar to you.

Their thesis is that these and other visionary companies are driven by a clear and consistent vision of themselves underpinned by a long term view of the world. On the one hand these companies are characterised by a clear vision and sense of direction, they have a purpose beyond profit, they have a fixed core ideology, they are conservative around the core, they pursue big hairy audacious goals, they have almost cult like cultures and they invest for the long term. But on the other hand they are also pragmatic in the pursuit of profit, they engage in vigorous change, they are bold and take risks, they are opportunistic and experiment and they are adaptable.

This is a tall order and not surprisingly, few companies reach these heights. Would any Australian public company meet these criteria?

According to Warren Buffett there is no fundamental difference between buying a business outright and buying shares in that business. I am not sure that I entirely agree with this view. However, I wholeheartedly agree with his underlying principals, which are

Is the business simple to understand?
Does the business have a consistent operating history?
Does the business have favourable long term operating prospects?
Is management rational?
Is management candid with its shareholders?
Is management beholden to institutional shareholders?
Focus on return on equity not earnings per share
Focus on cash flows
Look for companies with high profit margins
What is the value of the business?
Can the business be purchased at a significant discount to its value?

Essentially, Buffet is a contrarian investor looking for long term value, particularly value that the overall market has failed to identify. Buffet was widely criticised for his scepticism of the tech boom. He was called yesterday’s man. Indeed so many experts said that the world had changed that it must have. But we now know better, the world had not changed and indeed the durability of Buffet’s principals was well proven.

We spoke earlier that the challenge for investors is to pick those companies that are undergoing change. J Dennis Jean-Jacques addresses this issue in his book “The 5 Keys to Value Investing”. His five keys are

Is this a good business run by smart people?
What is this company worth?
How attractive is the price, and what should I pay for it?
How realistic is the most effective catalyst (for change)?
What is the margin of safety in my purchase price, in other words what is my downside risk?

These keys are very similar to Buffets principals. But he raises the important issue of the catalyst. What we are looking for is an event or series of events that will cause some underlying change in a company’s prospects. These could be some long term change in an industry’s dynamics or they could be single events such as an acquisition or change in management.

As we said earlier there is a lot of noise in the market, not just rumours and speculation but even company announcements provide confusion and often suffer from lack of clarity. The market inevitably gets very upset with a profit downgrade or unexpected profit fall and it gets terribly excited with the reverse. However, the market does not always ask whether these are due to some short term factors that will soon correct or whether it represents a fundamental change in prospects. In looking for successful companies we are only interested in fundamental change.

We have spoken a bit about catalysts for change and the challenge in identifying those catalysts that will either lead to success for a company or maybe disaster. Investors price stocks on expectations. Often those expectations will prove to be unrealistic but nonetheless the market wants to believe either good or bad. There is a saying in the market buy on the rumour and sell on the fact. This only emphasises what we are talking about, but it also highlights that the market is prone to over-reaction. This provides opportunities for smart investors.

Typical catalysts are:

mergers and acquisitions
asset sales
replacement of senior management
poor profit results

Essentially what we are looking for is an accelerated growth strategy or a turnaround situation.

Two high profile senior management changes in recent years highlight the problem for investors of unrealistic expectations. John Fletcher moved from Brambles to Coles Myer in September 2001 with a huge reputation and despite admitting not having even been into a supermarket for many, many years was seen as a saviour for the group. Whilst he may indeed engineer a turnaround at Coles Myer, and the latest profit results are very encouraging, the challenge is proving to be much greater than expected.

Peter Smedley was appointed CEO of Mayne Nickless in July 2000 after several years rapidly growing Colonial into a major financial services group. He gained the nickname of pacman from his time at Colonial where he gobbled up a large number of businesses. A similar strategy was pursued at Mayne with disastrous consequences. This strategy is now being unwound.

In both instances the stock was quickly re-rated on the appointment of these gentlemen with expectations of quick results.

Another interesting example occurred with the appointment of Roger Corbett as MD of Woolworths some years ago. The stock was initially marked down because the favoured contender missed out. How ironic that Woolworths has been a star performer under Corbett’s leadership. If my meory serves me correctly, the market reacted the same way when Corbett's predecessor. Reg Clairs was appointed. History truly did repeat.

Mergers and acquisitions provide the greatest risk to investors. Not only is there execution risk there is a great risk of unfulfilled expectations. And the risk grows in line with the scale of the deal. There seems to be a problem, especially with the press with overseas acquisitions. There is an inordinate focus on failures and relatively little discussion of the successes. And I'm not sure whether there is any difference in success rates between local deals and offshore deals. Nonetheless, the larger the deal and the greater potential impact on the company, the greater the expectations and the greater the risk.

It seems to me that the risk is mitigated where the target is in the same industry, shares the same core competencies and values. In effect the risk would seem to be minimised where the acquisition is a bolt-onto the existing business whether in Australia or overseas. The risks are highest when the acquisition is a diversification from the existing business, regardless of claimed similarities in customer base, market dynamics and so on.

Noise is the other problem. This typically occurs with events that affect profits; a change in demand, new competition, price changes, regulation changes and so on. The market will often react as if these changes are catastrophic where in reality the impact is only short term. A mistake the market often makes is to assume that companies operate in a static environment whereas environments are dynamic. What the market often misses is the response and counter response. Accordingly, reported profit changing events may only be temporary and have no lasting fundamental impact although the market may have priced a stock as if there were.

The challenge for investors is to look at the particular event or catalyst and to figure out the underlying expectations and assumptions and to make a judgement as to whether they are realistic, especially the time frame and especially whether the price is reasonable.

I consult to small and medium sized businesses by helping them to achieve success in their business. In my view there are five keys to running a successful business and it doesn't matter whether that business is a corner milk bar or a multi-billion dollar corporation, the basic principals are exactly the same.

There is no magic formula in running a business and there is no quick, easy path to success. Building a successful and valuable business is not rocket science. Success comes from a lot of hard work. Having said this however, there are five keys to achieving success in business. They are

1. Understand your business

2. Know your customer

3. Set objectives

4. Have a clear strategy

5. Focus on the money

The challenge for investors is to recognise these factors in the company's they are analysing. This is not always easy, but hopefully there are enough tell tale signs to make an informed decision. More importantly, hopefully the signs can read of impending change, maybe of a company establishing a platform for success or a successful company starting to slip.

Lets have a look at these factors.

1. Understand your business

Customer don’t buy products and services, they buy a solution or a value proposition or an experience. Whilst this sounds like marketing mumbo jumbo, it means that what is important is not what a company sells or does but rather what makes one company different from its competitors. Large diversified companies are essentially no different. What we are looking for is a company’s vision and mission statement, its values, an understanding of its competitive advantages, its core competencies and its strengths and weaknesses.

My view is that a company exists to serve its customers. It doesn’t exist for the benefit of management or shareholders. Shareholders in particular are rewarded for the risk they take in providing capital. But too often we see vision and mission statements expressed principally terms of benefits to shareholders. Not everybody agrees with this view, however, I fail to see how long-term success is possible where the customer is not placed at the head of the equation. Worse, many companies express their mission in terms that are so bland as to be meaningless.

Does this sound familiar

“Our company’s primary mission is to protect and increase the value of its owners investments whilst efficiently and fairly serving the needs of its customers. The company seeks to accomplish this in a manner that contributes to the development and growth of its employees, and to the goals of countries and communities in which it operates.”

Buffet talks in terms of understanding what the company does. What you need to look for in an annual report and other corporate material is clarity and a clear sense of purpose.

Lets look at some examples, good and bad.

“Chiquita aims to be the dominant player in the production, processing and marketing of horticultural and food products in its chosen categories and markets.”   Chiquita Brands South Pacific. This is a good example that is clear and to the point. The company goes on to describe its criteria for dominance.

“To be a world-class full-service integrated telecommunications company helping Australian and Asia-Pacific customers and communities prosper through their access to innovative communications services and multimedia products.” Telstra not bad but a bit wishy-washy. World-class is a motherhood statement and I wonder what the point is of using the word “prosper”, which leaves the question begging.

“Our Vision

Inspiring Global Enjoyment. Whether through beer, wine, spirits, leisure or property, Foster's premium products inspire enjoyment around the world.

Our Mission

Foster's mission is to work together, respecting each other, our heritage, diversity, skills and knowledge to:

- Build premium quality, first-choice brands
- Deliver service excellence to customers and consumers
- Generate superior returns for shareholders
- Create an inspiring workplace
- Be welcomed in the communities in which we operate.”

This is very average. However, there is no insight at all into what drives the company and where it is going in the future and many of the items in the mission statement are nothing more than motherhoods.

“Mayne strives to provide superior outcomes for its shareholders and for customers and patients.” (2001 annual report)

That is not a vision and I think it says something about the company’s value system in placing shareholders before customers and patients. Again it provides no insight into what drives the company and where it is going in the future. To say it strives to provide superior outcomes is meaningless as after all is that not what every business should be about.

2. ***Know your customer***

This is about identifying and understanding the market. Is it a large or small market, is it fragmented and highly competitive or concentrated and stable, is it mature or growing, what is regulatory environment like, exports/imports and so on.

Rapidly growing companies, companies with large offshore operations and companies in IT and life sciences industries are sometimes difficult to understand. Also beware of companies that regularly change their structures and operations. So I refer you back to earlier dictums and avoid companies that you do not understand.

The tech boom was fundamentally flawed by a failure to properly understand the customer and the market.

Most companies, especially large companies, provide a great deal of detail about what they do.

3. ***Set objectives***

It seems so obvious that every business should have objectives. But then why do so few seem to have any? Certainly, companies express vague statements, which they may pass off as objectives but which are really nothing more than wishes or statements of intent.

Without objectives there is really no basis for measuring success. Objectives are something to aim for. They provide a focus for achievement over some time frame and they provide a framework for setting strategies to actively grow a business or even just to maintain the status quo.

An objective must be specific, measurable, accountable, realistic and time based.

This is probably the hardest key to gain some insight from company reports since few management's are prepared to publicly state an objective, if they have one, since to do so sets themselves up for failure. Nonetheless, some insight can be gained from closely looking at company presentations to analysts, which are now usually available on the Internet.

4. Have a clear strategy

The corporate vision is what they are broadly aiming for or seeking to achieve and expresses its reason for being, objectives are targets; strategies are how you get there. Riding a boom in demand is not a strategy; that is keeping your fingers crossed. Figuring out how you are going to increase market share and boost margins when the boom fizzles out is a strategy. Typical corporate strategies are cost cutting, restructuring, acquisitions and product or market diversification.

Positive strategies focus on growth particularly revenue growth but also margins. These are positive because they focus on company's strengths and their competitive advantages and core competencies. Negative strategies focus primarily on cost cutting and largely on addressing weaknesses.

Having a strategy is one thing; successfully executing it is another. This requires that you be focussed on your market, that you understand the resources required to achieve your objectives and that you understand the strengths and weaknesses of your business and your competitors as well as the market dynamics. This last point is no less important for a major corporation as it is for a small business. In fact too often are great strategies laid waste by poor execution.

Lets look at some examples.

On 31 December 1998AMP undertook a major expansion of its UK operations with the acquisition of NPI. This acquisition was a disaster and the UK operations now threaten the overall survival of this company. The managing director was quoted in September as saying that the foray into Britain was a disaster because it was the wrong business in the wrong place at the wrong time. The current strategy is to hive off the UK operations into a separate company with shares distributed to AMP shareholders. This strategy is obviously designed to protect this Australian base from a very a weak UK business which maybe unsaleable.

In the late 90s there was considerable consolidation of the banking industry. Westpac in particular acquired Challenge Bank in Perth and Bank of Melbourne. It also acquired the Trust Bank in New Zealand. This strategy was well executed and would be deemed successful although it may be arguable whether Westpac fully retained the market share it acquired. As these were so called in-market mergers, the execution risk was relatively low and potential synergies and cost savings were high. The greatest risk was in terms of price paid and customer alienation (for example AMP and GIO and Commonwealth Bank and State Bank of Victoria)

On the other hand, most banks have aggressively pursued strategies to expand their exposure to wealth management. National Australia acquired MLC and now has its eyes on AMP, Commonwealth acquired Colonial, Westpac acquired BT and Rothschild, St George acquired Sealcorp whilst ANZ has an alliance with ING. The underlying rationale for this strategy and the specific initiatives was to protect the overall asset and deposit base of each of the banks in the face of the enormous growth in superannuation as well as the opportunities to leverage off the infrastructure associated with its huge customer base. The cross selling opportunities were perceived to be very high.

These strategies have been far less successful than was anticipated. Probably the most successful has been National's acquisition of MLC and St George's acquisition of Sealcorp. Sealcorp and MLC differed from the other acquisitions in that they primarily provided administration and product manufacturing and distribution services. They were not funds managers. The core competencies were in tune with those in the banking operations and the cultures were similar. With the funds managers, Colonial, BT, Rothschild etc, the core competencies and cultures were vastly different leading to major problems and ultimately major writedowns.

"Mayne will achieve this vision (what we saw earlier) by:
Developing its leading service proposition in its core business
Developing its leading service proposition in its core business competencies of health care and logistics
Growing its business positions in its home market of Australia, and continuing to broaden and deepen its presence in selected markets internationally
Building strength in the business brands to underpin the value of the corporate brand
Delivering innovative solutions for customers and patients by mobilising the group's technological capacities

Maximising earnings by leveraging business efficiencies within and across its operations, whilst ensuring quality outcomes for customers and patients
Assigning capital to core assets and businesses to ensure optimum shareholder returns
Fostering an organisational environment which allows staff to achieve levels of excellence in a way that leads to the achievement of the stated business goals"

A good statement of strategic intent but the proof was in the pudding so to speak.

5. ***Focus on the money***

   Just as it is imperative that anyone running a business, be it large or small to be in full control of the finances, anyone seeking to analyse a company should be able to fully understand the finances. You should be aware of profit margins, costs and the contribution to sales and profits of the various products or services. Focus on cash flows and balance sheet quality. Look at the level of debt and funding capacity. Ultimately the bottom line is not how much profit the company makes but rather how much surplus cash flow it can generate, the return on capital employed and the value of the business (Back to Buffet's principals).

   This should seem quite obvious and straight forward but keep a look out for regular write-offs or write-downs, restructuring provisions, changes to divisional structures and changes to accounting methods for suspicious signs.

We have spent a lot of time canvassing what makes a successful company but you may rightly ask how do we as investors identify these companies especially as some of the factors that I have raised are very difficult for an outsider to explore. In particular, objectives are rarely quantified publicly and strategies are often not spelt out, but rather are left for us to unravel after the event.

My approach involves four steps

- Look at key financials
- Look at the business drivers
- Look at the likely trends
- Identify change or risk catalysts

Look at the key financials

We use financials to understand where the company has come from, where it is heading and what are the financial constraints in terms of where it could or might go. The financial ratios I look at are

Sales growth over the past 3 to 5 years

Profit and Earnings per share growth over the past 3 to 5 years

Trend in profit margins over three years

Return on shareholders equity

Net debt to equity ratio

Trend in cash flows over the past 3 to 5 years

From these numbers you are going to very quickly get a picture of how the company has performed and its likely prospects in the absence of any change in strategy or operating conditions.

Look at the business drivers

This is essentially about understanding what the company does and its business structure.

Look at the likely trends

This is about understanding the operating environment of the company including the competitive environment.

Identify change or risk catalysts

Having already decided whether a company has been successful or not this is an evaluation of what could cause a fundamental disruptive change, for better or worse. There are innumerable economic and non-economic forces that could be catalysts but the most typical are changes in the competitive environment or the broad economy, management changes or a radical change in strategy say with an acquisition.

This approach will quickly highlight for you those companies that are successful and those that are not but it also provides a mechanism by which you can begin to make some judgements as to whether or not a change one way or the other is likely or possible.

Lets now look at some companies using my approach and see if we can see what we can come up with:

Wesfarmers

Coles Myer

Woolworths

Southcorp

As a final thought you may very well ask what about corporate governance. To this you may very well add questions about employee relations, social responsibilities and environmental obligations. There is no doubt that successful companies will generally score highly in these regards. But because of the increasingly legalistic approach to these matters, unsuccessful companies face the same obligations. Nonetheless, a major failure to meet these obligations will point to problems.

In summary, Understanding what to look for in successful companies is key to being a successful long-term investor. The market is rational and over the long term will recognise and reward success. Running a successful company is not rocket science. The keys are simple, what is the business about, who are the customers, what are the objectives, what are the strategies and don’t forget the money. Being able to identify risks and potential catalysts that will change the fortunes of a company will help to ensure that your portfolio is performing at a high level and in tune with your personal objectives.

Thank you