Investment Market Update No. 3

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Editorial

Welcome to our September investment market update. Thank you for the feedback on our first two editions and we trust you will enjoy this one just as much. We also welcome our new readers.

In this issue we cover:

1. Deflation – is it a concern?
2. Takeovers and the takeover premium.
3. Cracow – a town on the move.

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Deflation – what is it?

Deflation, which is a sustained fall in the price of goods and services over time, seems to be getting more than its fair share of press coverage recently. The main reason is that the Bank of England and Federal Reserve have stated that they have one eye looking for signs of deflation. Another reason is the prolonged period of deflation in Japan (although there are more significant reasons for Japan's economic woes than deflation).

If deflation means that the prices of goods and services are decreasing, how can this possibly be a bad thing? Each year consumers are spending less and less for the same basket of goods and services, which is good for them. Deflation also means that businesses are receiving less for the goods and services they provide, even though the fixed costs of production are the same.

What causes prices to fall?

Economic theory suggest that an oversupply of a good leads to a reduction in the price of that good to bring about equilibrium (where demand equals supply) in the market. Other factors such as increased competition and improved technology also cause prices to fall. Consider the recent announcement by Virgin Blue that they will soon be flying to NZ. Qantas responded by announcing they will match Virgin's fare, which is 30 per cent lower than the current airfare.

When discussing deflation in Japan some commentators fail to discuss the impact of competition. Deregulation of a number of previously inefficient Japanese industries has brought about an increase in competition. If falling prices are due to this, policy makers should not be concerned. Instilling confidence in businesses and consumers and achieving positive economic growth should provide the impetus to a recovery. The only question that remains is how to go about this. Neither low interest rates nor an expansion in money supply has worked (S*ource: Time Asia Magazine: Japan's Deflation Dogfight – March 3, 2003*).

Maybe it is time for the Japanese PM to deliver. He was elected on a platform of economic and business reform, but to date has failed to deliver. Deflation is a convenient political scapegoat that will continue to grab all the headlines while the tough decisions to reform are buried under the rhetoric of controlling deflation. Instilling confidence in consumers by reforming business, especially the banking sector, will deliver the desired results – economic growth, a stable economy, low unemployment and price growth. Failure to act will see the world's second largest economy stumble from recession to recession.

Is deflation a concern?

The short answer is no because every market moves in cycles. This is true even for sporting teams. They perform well (or poorly), coaches change, old players retire and younger players develop. The team then moves to a period of underperformance or out-performance depending on where they were in the cycle (eg the Brisbane Lions and Sydney Swans).

Japan has been in a trough much longer than expected but they will recover and prosper. Competition and technology are causing prices to fall. With this comes greater economic efficiency as businesses strive to keep costs under control. Inefficient businesses will close, whilst good quality companies will continue to perform well regardless of the economic cycle.

Mergers, Acquisitions and Takeovers

Although all three are similar there are some differences for shareholders.

A merger is a friendly process that combines two companies for the greater good of the single entity (an example is BHP merging with Billiton). On the other hand, a takeover is usually hostile, as was the case with AMP's (botched) takeover of GIO, while an acquisition means the purchase of an asset of one company by another. A recent example would be AWB acquiring Landmark from Wesfarmers.
(S*ource:www.telstra.com/money/sharemarket/Sharebasics_article7)*

The recent raid on AMPs shares by NAB could be seen as a precursor to a possible takeover. AMP's Managing Director, Andrew Mohl, reported that he spoke to a number of fund managers urging them not to sell their shares in AMP (*source: news.com.au 11/9/03).* AMPs share price at the close of trade on August 27 (the day before NABs raid was made public) was \$5.15. It opened on the 28th at \$6.21 and is trading at \$6.62 today. This is a 28.5 per cent increase in the share price in a little over two weeks.

This rise is consistent with research undertaken by McKinsey and Co. that shows that shareholders in companies subject to a hostile takeover generally receive a 35 per cent take over premium. For friendly mergers the premium is about 20 per cent. (S*ource:www.telstra.com/money/sharemarket/Sharebasics_article7)*

Shareholders of acquiring companies (those parting with the cash) earn very small returns by comparison. NAB shares fell \$0.82 or 2.5 per cent between when they started to buy AMP shares and the market opening the next day. From August 28 to September 12 they are down a further \$0.53 or 1.68 per cent. Research from the US indicates that companies that attempt to grow shareholder wealth through acquisitions rarely do so.
(*source:www.telstra.com/money/sharemarket/Sharebasics_article7).*

There are a few high profile examples of failed, or difficult marriages between Australian companies. The CBA purchase of Colonial is one. Since CBA purchased Colonial at the height of the bull market in 2000, CBA shareholders received total returns 20 per cent lower than if Colonial had not been purchased (source: The AFR, 17/9/03).

Merrill Lynch has recently reported that mergers between banks don't make much sense, especially for shareholders in the acquiring bank. The report highlights three negatives: a 5 per cent decrease in revenue and market share; that the cost benefits rarely clawback the revenue losses; and shareholders in the acquiring company can expect their shares to be worth 12 per cent less than their peers 18 months after the deal *(source: The AFR, 17/9/03).*

Cracow – On the Move

From time to time a new gold prospect will emerge and it will excite the market with the quality of its assays and the size of its reserves. It has happened before and it will happen again. Seldom, it seems, does an old reserve recover.

The exception to this rule is Cracow (and potentially Mount Morgan). Newcrest Mining and Sedimentary Holdings have established a new joint venture to re-open the gold mines at Cracow. The joint venture is targeting their initial operations at the Royal, Crown and Klondyke shoots and ultimately the Severeign and Empire structures.

For a cost of \$48 million the operations expect to generate 680,000 ounces over six years. There does appear to be significant upside potential, but as with a lot of mining ventures there can be considerable risk too. The risk of the project comes in various forms including currency and more importantly, a lack of gold.

Exceeding the production estimates will improve the value and usefulness of the project to Newcrest. If all goes well we may see Newcrest buy out Sedimentary's holdings. On the other hand if production targets are not met we expect Newcrest to exit the arrangement. Newcrest is presently trading at \$11.28 and Sedimentary at 25.5 c.

If nothing else, the reopening of the mine will be good for the people of Cracow.

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