

Prosperitas

Prosperitas: Latin for prosperity & good fortune

ISSUE 4 • February 2007



Adapting in a world of change

What does the weather and drought have to do with wealth creation? If you are Australian – plenty. There was a seemingly distant moment in time when the Australian economy rode proudly on the sheep's back, the success of the agricultural sector was central to our economic fortunes.

While our farmers are presently struggling to manage the challenges of yet another dry winter followed by a scorching summer, our miners are supplying an unprecedented volume of iron ore to various parts of Asia. The depth of steel demand has created unprecedented prices for the resource and our economy is riding high once again.

When the music stops in Asia, will the economic disguise of prosperity created by this precious mineral have delayed our search for a sustainable water solution for our agriculture sector beyond the point of return? While the opportunity remains to become Asia's market garden, will we simply become their open-cut mine? As we continue to lift our buckets in the bathroom, let's hope that our politicians and industry leaders begin to lift their collective games in this regard.

Feeling slightly below par in the fitness stakes since your return from holidays? Our editor (by the way, his profile is on the back page) has included numerous health tips in an effort to correct the fitness programs that may well have been de-railed over too many recent coastal BBQ's. Be strong, be committed and may the force be with you all.

In this quarter's edition of Prosperitas, we have also attempted to demystify the investment phenomena that has been the recent boon in Private Equity investment. Where have some of the iconic Australian companies gone and what does the privatization of company achieve for the investor? Complimented by a further article dealing with the often confusing jargon that surrounds the listed equity market, pages 2 and 3 provide the educative content of our newsletter and we trust that you will find these pieces at once useful and informative.

Once again, we welcome any and all feedback relating to our services and more particularly this publication and wish you all volumes of prosperity throughout 2007.

Martin R McIntosh
Managing Partner

Private Equity and Management BUY-OUTS

Many of our clients will be aware that over the last 12 months, there have been a number of large Australian companies that have done deals with Private Equity Investors to sell all or part of their companies. Some examples include; Seven Network, Publishing and Broadcasting and Qantas. This article examined the Private Equity phenomenon in further detail.

What is Private Equity?

Private Equity is the term used to describe investments in non-listed companies. As the companies are not publicly traded – the term “private” is used. Because the investor becomes an owner of this private company – the term “equity” is used.

The reason businesses require capital are varied and can be broadly divided into three categories:

1. **Start-up** – financing for businesses less than 30 months old to develop products, e.g. R&D on drug or computer programs. Often called Venture Capital.
2. **Expansion** – funds are required to develop the business, particularly manufacturing and distribution capabilities or to finance an acquisition.
3. **Management Buy-Outs** – funds required to facilitate the company being purchased by its management team.

The majority of Private Equity deals announced over the last year have involved Management Buy-Outs. This is where companies have been purchased by Management (with the assistance of a Private Equity investors and a significant amount of debt from banks) to purchase companies and then subsequently remove them from the Stock Market.

Why have Private Equity Buy-Outs become so common in recent times? There are two main reasons for this:

1. **Excess Liquidity in investment markets.** There is a lot of funds both in Australia and globally which are looking for a home to be invested. To a large extent, this is driven by compulsory superannuation contributions which mandate that a percentage of everyone's salary be invested for their long term retirement benefits. Large Superannuation Funds and Pension Funds have become more comfortable with investing a portion of their portfolio in Private Equity investments to gain superior returns and gain diversification away from traditional asset classes such as; shares, property and fixed interest.

Furthermore, banks are now more willing to lend large amounts of money to help finance these buy-outs at low interest rates and without bricks and mortar security. This is comparable to an individual person buying a Business and the bank lending money on the basis that the Business will generate reliable long-term cashflow, without the need for the individual to put up their house as security!

2. **Strong Balance Sheets and Cashflow of Australian companies.** Many large companies in Australia have very strong market positions and operate as monopolies or oligopolies. For example, Coles Myer and Woolworths have the lion share of Supermarkets in Australia and generate strong cashflow regardless of economic conditions. Qantas is the beneficiary of substantial Government protection as the flagship national airline and competitors face significant barriers to entry.

These businesses are ideal for Private Equity investment because they have reliable cashflows. Furthermore, many of these Business have very little debt and banks are willing to lend large sums of money to finance the buy-outs. Through the use of this debt, Private Equity investors are able to multiply their investment returns and generate a far greater return on equity than if the company remained listed on the ASX. In general, ASX listed companies would not tolerate these high levels of debt.

Management of private companies also have more flexibility to make tougher decisions (such as reducing employees) as compared to listed companies which are under greater scrutiny by Unions and the public. They can also keep their corporate information such as marketing plans secret from their competitors as compared to listed companies which need to furnish public annual reports and provide regular disclosure the Stock Exchange.

Are Management Buy-Outs good for investors?

Management Buy-Outs for ASX Listed companies will invariably be offered at a premium to the current share price of the company. As such, existing investors in these companies will experience a sharp appreciation the value of their shares. For example, the proposed offer by Airlines Partners Australia for Qantas shares is \$5.60. This offer is 33% higher than the closing share price of Qantas of \$4.20 on 6 November 2006, the day before the first speculation about the offer.

However, there is no doubt that the Private Equity investors (and Management) believe that the long term value of the company is substantially higher than their offer price, or the offer would not be made. Therefore, the question is whether or not the original owner of the shares would be better off if they are able to continue to hold their investment for the long term and benefit from the increase in value which the Private Equity investor is trying to capture. On the other hand, Private Equity has greater ability to use debt and make management changes as compared to listed companies – so perhaps, the Businesses are worth more in their hands!

Another interesting issue is the role of Senior Management in the buy-out process. Investors expect Management to be focused on running the company for the benefit of all shareholders, not trying to engineer Buy-Outs which may place a larger portion of the Company and future gains in Management and Private Equity investors hands!

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Protecting your assets – all of them

Your business is successful, you have accumulated significant assets, and your financial future looks rosy. You probably have insurance protection for your house, contents, car and business premises. But what have you done to protect all your assets from litigation, bankruptcy, and the inevitability of death?

Wills and Succession Plans

Having an up-to-date Will is essential. Key issues will be ensuring that assets pass to the people you choose and any tax liability is minimised. Setting up a testamentary trust can be an effective way to ensure your beneficiaries retain control over the assets and they are distributed in the most tax-effective way.

If you are self-employed, having a succession plan is like a Will for your business. It can ensure that your beneficiaries can liquidate the value rather than being saddled with the business as an ongoing concern.

A succession plan must look after the needs of the departing owner and their family as well as those of the remaining owners and their families. A formal buy/sell agreement is often used to ensure everyone's rights are protected. Life insurance is invaluable to eliminate debt, extinguish personal guarantees and replace lost revenue. However, there are traps with capital gains tax and we recommend that you seek appropriate legal advice first.

Added benefit of Superannuation

One strategy worth considering is to hold retirement assets outside of the business. Superannuation provides many benefits for business owners. These include

- Protection of assets from creditors up to the pension Reasonable Benefit Limit (\$1,350,000 in 2006/2007 financial year).
- Assets are not part of your estate and can be distributed by the fund trustees in the way you direct without challenge from other possible beneficiaries.
- Special Capital Gains Tax concessions for small businesses on the sale of a business, and
- Tax deductibility of contributions.

What to do now

Planning Partners can assist in Asset Protection and also have a number of relationships with Solicitors for preparation of legal documents. If required, please contact us to discuss your particular Asset Protection requirements.



Let's get educated ... ABOUT INVESTING IN COMPANIES

You'll often see labels given to companies in the financial press or in reports from fund managers. Here is a simple guide to the most common ones.

"Cyclical" companies react to economic changes. Construction and building supply companies do well in boom times. In a recession, people put off bigger purchases so carmakers will do poorly but breweries will be less affected.

"Defensive" companies are ones that will continue much the same through economic cycles. Drug firms are an example because if you're taking heart medication, you're not going to stop because of an economic downturn.

"Seasonal" companies experience different levels of business at various times of the year. Department stores see sales surge during the Christmas season. More soft drinks are sold in summer.

"Blue chip" companies are well established and are known for being solid, relatively safe investments. They grow steadily, usually paying dividends. Examples are the big banks and retailers.

"Growth" stocks, favoured by aggressive investors, grow faster than the market average. They often don't pay any dividends, using their cash to continue growing. Their stock prices often go up and down – quickly. Telecommunication and IT companies fall into this category. Note that supermarkets were growth companies once but they are very different today.

"Value" stocks are where the share price is lower than what is considered to be fair value. They may be out of favour in the short term but are expected to recover.

"Income" stocks may not grow too quickly, but they pay fat dividends. Many blue chips and businesses involved in property management pay high levels of income but have lower growth potential.

Companies can often fit into several categories. Investors may seek companies with several characteristics, such as those that are both growing and are valued attractively.

Planning Partners construct direct share portfolios for clients with a balanced exposure to various types of stocks depending on clients' risk tolerance and general market conditions. Professional Fund managers may also have a bias towards particular stocks and are often blended in portfolio construction, to provide an outcome in line with expectations in all market conditions.





Reuben Zelwer

Success is... *Striving to improve whilst being content with what you have.*

New clients always ask me...
So how long have you been doing this?

Great service is... *Setting and meeting clients' expectations.*

In ten years I see myself...
In the same job!

My top three tips for running a business are... *(i) Be good to staff (ii) Be good to clients (iii) Be good to yourself!*

I'm reading... *'The Book Thief' by Markus Zusak. Incredible.*

Last movie I saw was... *'Happy Feet' with my kids.*

My favourite TV show is...
NYPD Blue, although now it has been relegated to late night television!

My favourite gadget is...
Mobile phone hands free kit in my car.

My favourite way to pass a day is... *Breakfast in the morning with the wife and kids. A hit of tennis. Watch Collingwood win at the footy. Dinner out with the Missus.*

One thing I've always wanted to do is... *Ski all over the world.*

My favourite quote is... *'You can take a horse to water, but you can't make it drink.'*



ABN 24 943 115 344
Level 1, 587 Canterbury Road
Surrey Hills Victoria 3127
PO Box 76, Surrey Hills 3127
T 03 9830 0366
F 03 9830 7028
www.planningpartners.com.au
advice@planningpartners.com.au



Exercise AND Fitness

As the New Year begins, some of us tend to draw up a long list of resolutions with the best intentions in mind. However, come April or May these have often been left by the wayside because we may have set our sights too high.

Rather than deciding to join a gym, eat healthier, quit smoking, work harder and save money for a holiday all in one year, why not commit to just one or two realistic resolutions that you know you'll keep.

Instead of focusing on a multitude of health goals, resolve to simply lead a healthier lifestyle that encompasses all aspects of your life – improved general fitness, loads of fruit and vegies and a happier attitude. That way, you can't quit!

Try not to eat too close to exercise, as the body shifts energy towards digestion of the last meal and away from muscles, so peak performance will be lower and benefits won't be the same. Make sure you have enough energy by timing your workout about half an hour after a light snack, an hour after a large snack or light meal and leave at least two to three hours between exercise and a heavy meal.

A light snack about 30 minutes after a workout will replace lost energy and repair any muscle damage. A snack containing carbohydrate and protein in a ratio of 2:1 is optimal, such as a plain yoghurt, a piece of fruit and 30g of low-fat cheese, a slice of wholegrain bread with ricotta cheese, a fruit smoothie, or 40 grams of mixed nuts and dried fruit. Make sure to drink plenty of water before, during and after exercise to replace lost fluid.

And don't aim for a quick fix – contrary to popular belief, consuming sweets such as lollies or chocolate before exercise does not provide a quick burst of energy, but may cause a rise in insulin followed by a drop in blood sugar leading to fatigue.

Private Equity and Management Buy-Outs

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Finally, there is the issue of fees, bonuses and commissions earned by Management and Merchant Banks which structure the deals. This is not such an issue for the investor selling their shares, but will be a concern for the Private Equity Investor who is taking on most of the risk of the investment, but may face the prospect of having their returns peeled back due to high fees. Returns from Private equity in Australia have been an average 14.8% per annum over the past 5 years. Whilst this is a reasonable return, there is a high level of risk in these investments due to the amount of debt in the transactions.

Individuals can get access to Private Equity investments through professionally managed funds or through ASX listed investment companies which take positions in Private Equity deals. For example, Allco Equity Partners (AEP) is an ASX listed investment company which will be taking a large stake in the Qantas part of the Buy-Out and gives investors an opportunity to gain exposure to the deal.

Overall, we have little doubt that that the Private Equity phenomenon will continue in 2007 given the strong market conditions and availability of funds for investment and borrowing. As such, we will continue to evaluate strategies to assist our clients to benefit from this exciting development in financial markets.