

# economic & investment horizons

Grant Thornton 

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## Barbarians at the gate?

Grant Thornton Investment Management's domestic equity portfolio contains Adsteam Marine, Rural Press, Origin Energy/AGL Energy and Rinker, all of which are subject to corporate takeover or activity. In addition, there are significant private equity "plays" in progress with Alinta, Qantas and, previously, the Coles Group.

### Two key factors contributing to this phenomenon are:

#### 1 Agency costs

These are often cited as the key reason for transforming a public company into a private one. Agency costs arise as a consequence of the relationship that exists between management (agent) and shareholders (principal). The costs are both direct and indirect. Private equity assumes that it can reduce or eliminate many of these agency costs because it basically closes down the agency arrangement.

#### 2 Financial engineering

This gives rise to (short-term) financial manipulation and increased gearing. It occurs mostly to drive increased recognition of capital value and, of course, an exit through realisation.

The current economic and funding environment is highly advantageous, especially with the combination of historically low funding costs and the abundance of funds or liquidity. With company balance sheets "awash" with free cash flow, the current conditions of cheap and available funds make for an ideal environment for private equity groups whose "tool of trade" is debt. The recent hectic corporate activity has been dominated by the actions of these groups. Globally, private companies are also taking advantage of these lower funding costs to participate in the consolidation of various industries (the cash offer for Adsteam Marine is a perfect illustration of this).

The GTIM equity portfolio looks for companies with appropriate financial accommodation and, most significantly, businesses that generate growing free cash flow. In light of future economic uncertainties, we believe businesses need to be prudent in envisaging possible adverse economic or sector events which impact on future profitability. We do not, however, encourage inefficient or "lazy"

balance sheets. This can sometimes occur because a company's management wants to substantially retain profit for future growth. We reject this approach as it gives rise to an indirect agency cost, with management believing that it is a superior portfolio investor compared to its shareholders. Empirical evidence suggests that this is not the case, and is accordingly an unacceptable agency cost. Private equity or any well-run business with a strategic fit would be entitled to attack this agency cost of a lazy balance sheet.

A better alternative to short-term private equity would be for existing management to remove the agency cost of lazy balance sheets themselves. How? Excess capital should be returned to shareholders – the owners. This can occur via increased/special dividends or alternatively share buyback schemes. If excess capital is left to laze away on the balance sheet for current or future management to potentially squander, then expect corporate or investment opportunists to come knocking, or simply kick the door down.

# The brave new world of prolific liquidity

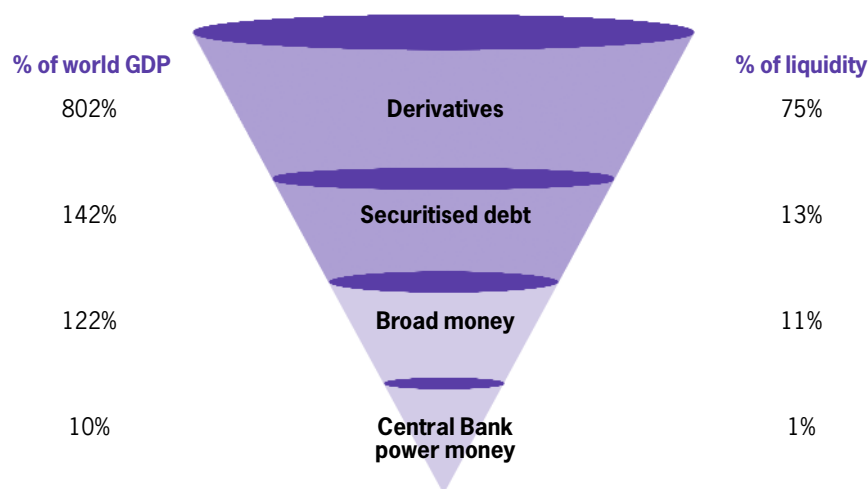
Today's financial liquidity environment is basically upside down when compared to just ten years ago. To understand what this means, consider the cone diagram below. What you can see is that traditional sources of liquidity comprising Central Bank power money and broad money represent just 12% of liquidity, whereas the "new" liquidity sources represented by Securitised Debt and Derivatives represent 88% of world liquidity or 944% of world GDP. This has important implications for financial markets and the world economy as a whole.

Central banks have control or influence limited to the bottom two elements of liquidity (or 12%). This leaves the "new" liquidity categories, representing 88% of total liquidity, controlled and largely self-regulated by the market. Accordingly, derivatives and securitised debt markets have little or no prudential oversight. The risk of the unknown is therefore limitless. What really is in question is whether the world's financial system can meet future adverse events and volatility in a satisfactory manner given these new liquidity forms. The risk is systemic failure in financial markets with consequential economic failure.

It is not all bad news. These new liquidity instruments are indeed significantly moving and repackaging risks away from the original risk party to parties who are capable, discerning and prepared to accept the commercial reward of financial risk. A clear example is hedge funds. The self regulation of financial markets, where participants are short-term focused, is of course not an appropriate medium to long-term recipe for financial stability. There are financial market efficiencies to be had, but given the direct impact on credit creation and the broader flow-on to

economic policy, it is difficult to see why central banks should not have as a minimum a role of collecting data, so as to understand and comment on financial risk that effects financial stability, but probably more substantially an overseeing and proper prudential role.

These are the new, interesting and potentially fraught times we operate in under the ever-developing deregulated financial system, which of course is really no more than an "adolescent" having only been born in the mid-1980s.



Source: BIS/Grant Thornton Investment Management

## Sigma Pharmaceuticals Limited

Sigma Pharmaceuticals Limited (ASX:SIP) was introduced to the GTIM portfolio in October 2005, originally as Sigma Company Limited. A merger with Arrow Pharmaceuticals resulted in the formation of Sigma Pharmaceuticals Limited in December 2005.

### The business

Sigma is an integrated healthcare company. They are a leading manufacturer and marketer of prescription, over-the-counter and generic pharmaceutical products.

Sigma also has involvement in retailing pharmaceuticals under the brands Amcal and Guardian. Since the merger with Arrow Pharmaceuticals, Sigma has grown to become Australia's largest oral generic pharmaceuticals business.

### The financials

SIP has achieved steady growth over the last five years, with after-tax profit increasing 56% to \$49.4 million for the 12 months ending 31 July 2006. An increased exposure to generic medications has increased sales growth

since the acquisition of Arrow Pharmaceuticals, contributing to a 3.1% increase in market share. Sigma's market share now stands at 33.5%.

### The future

With a growing market share, increasing profitability and a continued focus on its core strengths, Sigma is a strongly led business with excellent growth opportunities. Further synergies are expected to be generated from the integration of the Arrow Pharmaceuticals business.

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