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measuring success

Measuring business performance correctly rather than conventionally is the key to investment success.

Story Roger Montgomery

Business performance: merely mentioning it can cause a yawning pandemic. Yet business performance is the single most significant determinant of long-term investment returns. If you want to invest in businesses listed on the stockmarket, then your ability to understand and assess the economic performance of a business will be the most important contributor to your results.

Importantly, economics rather than accounting plays the most vital role in the success or otherwise of an investment. This is because accounting is largely backward-looking while investment decisions need to be made based on the economic reality and prospects of a business.

For example, most years Qantas reports an accounting profit. The 2009 year was no exception with Qantas announcing a consolidated profit of $123 million. This includes a contribution from a change to the accounting treatment of the Frequent Flyer program, the contribution from the profits of the Frequent Flyer business itself and a relatively substantial profit from the sale of Qantas Holidays, This profit however represents what is left after the subtraction of the depreciation expense. According to the 2009 annual report, depreciation and amortisation amounted to $1.4 billion of which $720 million related to owned aircraft (and parts) that are depreciated on a straight-line basis over a 20-year useful life.

Imagine the airline's books include a 19-year-old plane. The depreciation expense related to this aircraft will be based on the cost of the plane 19 years ago. It is highly likely that the replacement cost of such a plane will be significantly higher. It is therefore reasonable to conclude that the economic cost of operating an airline is not best estimated by historical cost accounting. If the line item depreciation were replaced with a new item called "provision for replacement cost of aircraft", the true economic cost would be more accurately reflected in the profit and loss statement. The cost, of course, would be significantly higher and an overall loss would result rather than a profit. And yet, Qantas pays dividends to its rather charitable shareholders. How can that be?

An accounting profit permits it, but an economic loss reflects the reality, which is explained by the performance assessment that follows.

Knowing which businesses are great and which are mediocre is the relatively easy part of investing. The hard part is being patient, waiting for the perfect opportunity and keeping your head when everyone is losing theirs. What follows is the easy part.

> The worst sort of business is one that grows rapidly, requires significant capital to engender the growth and then earns little or no money

INVESTING IN A BUSINESS

Imagine you own a business that requires you to invest $10 million initially. In the first year, it earns you $1 million profit, then $2 million the year after, then $3 million, then $7 million then $10 million and so on. Now suppose that you own a different business that requires the same initial investment and produces the same series of profits. There is one difference however – this second business requires you to reinvest half the profits back into the business each year just to keep it successful against its competitors. Which business would you prefer to own? Clearly you would prefer to own the business that doesn't require ever-increasing amounts of equity. The best businesses to own are those with the best performance and the most valuable measure of performance is return on equity. Return on equity is more useful than profit growth or revenue growth because it looks not only at the profits coming out of a business but how many dollars are required to go into the business to produce those profits.

Suppose we go back 10 years – to 1999 – and we have decided to start a business. We reach into our pockets and write cheques for $1.9 billion, using our own money, to kick the business off. That $1.9 billion represents our equity in the business. We also head down to the bank and ask for a $3 billion loan.

So the business in 1999 now has $1.9 billion of our equity and $3 billion of loans borrowed from the bank.

After the first year of being in business, the manager we hired to run it for us reports a profit of $515 million. Pretty good don't you agree? Half a billion profit on our $1.9 billion of equity is about a 25 per cent return. And it's always useful to compare this return on the equity invested to returns available elsewhere and you can't get that in a bank account!

Now fast-forward 10 years to the present day. Over the past 10 years, profits have gyrated and have been as high as $970 million in one year and as low as $300 million in another. But this year – our 10th year, the company will make only $100 million or so. That's less than a quarter of the profit we made 10 years ago, back in 1999. I am sure you are beginning to think this is not a great predicament and certainly not a great business, especially remembering that inflation over the last 10 years has made the $100 million of profit this year, worth a lot less than it would have been a decade earlier.

And what if, over the last decade, we had also tipped in another $2 billion of our own money and borrowed an additional $3 billion from the bank? And remember this hasn't really gone to growing the business at all. We have more staff, more machinery to serve more customers but inflation has made sure they cost more to service and our profit this year will be lower than 10 years ago!

So we have a business that we have been running for 10 years. We have tipped in a total of $4 billion of our own money and borrowed $6 billion from the bank and we are going to make about $100 million this year. That $100 million is equal to a 2.5 per cent return on the $4 billion of equity we have put in. If you take inflation into account it's even less. Remember it's always worth comparing returns to what you can get elsewhere? If you put $4 billion in the bank you would get a higher return with lower risk and you wouldn't have to worry about going to work every day to run the business either.

So do you think this is a good business? Do you think you would be happy to own it outright? Or do you think you would you like to try and get out of it?

The answer is that this is not a good business in terms of business performance. And yes, you probably would be thinking rationally to get out of it. But what might really knock your socks off is that this isn't a hypothetical example at all. The scenario is in fact describing the economic business performance of Qantas.

Qantas is a great Australian Icon and its people are collectively doing a world-class job. Indeed Qantas is regarded as the most profitable airline in the world. But you can see from an examination of the business' performance, that it would be very painful financially to own Qantas outright. From a purely capitalist perspective, I would rather own something else. A term deposit perhaps.

It is no wonder that Warren Buffett, the world's best investor, has said: "The worst sort of business is one that grows rapidly, requires significant capital to engender the growth and then earns little or no money."

PHOTOGRAPH: PINCASSO / SHUTTERSTOCK

RETURN ON EQUITY

The performance of a business should not be assessed by size, earnings growth or other common measures. The only important metric is return on equity. ABC Learning Centre's return on equity had fallen for five years and the year before its collapse was less than that available on a term deposit. Coles was earning a 27 per cent return on its $4.3 billion of equity but paying over five times the equity for Coles, as Wesfarmers did, must necessarily result in a substantial decline in those returns.

Over long periods of time, shares do a pretty good job of following the economic performance of the business that underlies them. Using the period described above for Qantas, its shares were trading at $3.32 in 1999. Today they trade at $2.85.

Business performance is best measured through the earnings power of the equity investment made – that is the money put in and left in. It's not how many dollars that come out of a business that best measures a business' performance nor is that important in determining your investment returns. Rather business performance is best measured by how many dollars are required to be invested in order to produce those earnings.

Ben Graham, the intellectual dean of Wall Street, said in the early part of last century that in the short run the stockmarket is a voting machine but in the long run, it is a weighing machine. In other words over long periods of time, the sharemarket does a rather good job of following the value of a business and the most valuable business is the one that produce the highest returns on equity. The best returns then come from the investments made in the businesses with the best performance.

Roger Montgomery BComm., SF Fin. sold his interests in the listed investment company and top-quartile funds management firm he founded.

Pre-register for his forthcoming book on how to pick the best stocks at **RogerMontgomery.com**