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Corbett's Fairfax still a leaky boat, says analyst

Your performance in the stockmarket is more a function of the boat you get into than who is rowing it.

You could have the Oarsome Foursome rowing your business, but if the hull is leaking they will merely have travelled the furthest before sinking. But sink they will. And one company that looks to be taking on quite a bit of water at the moment is Fairfax.

These are the thoughts I have as I consider the implications of Roger Corbett's appointment as chairman. I am also conscious of the observation that when a manager with a reputation for brilliance gets involved with a business with a reputation for poor economics, it is usually the business whose reputation remains intact.

Newspapers have had to change their models dramatically or die as readership and classified revenues decline. Just this weekend I noticed that the automotive section of my paper had fewer than a dozen cars listed for sale between the letters A and H!

Other major advertising revenue is also under pressure as the vast tracts of broadacre advertising real estate are replaced by the cheaply created and quickly populated pages of the internet.

Even Warren Buffett, once the most vocal exponent of the toll bridge-like virtues of owning the only newspaper in town, has more recently declared that he now would not buy newspapers at any price.

John Temple is the former editor, president and publisher of the *Rocky Mountain News*. Founded in 1859 it was Colorado's oldest and highest weekday circulating paper but it printed its final edition on February 27 this year.

Under Temple's leadership, and some of the smartest people in the industry, the paper won four Pulitzer Prizes and many other national awards for journalistic excellence. And yet it no longer exists.

Temple now writes a disarmingly frank blog, in which he first observes: "We didn't fully believe in the value of the web" and "Denver.com was available but the $50,000 price tag was considered too steep".

The *Rocky* was founded by the deep-pocketed EW Scripps, which today is still controlled by the founding family. Scripps started as a newspaper company, but navigated through the advent of radio, TV and cable — starting successful new media businesses each time. In the 1990s, after going public, Scripps diverted its cash to build lifestyle cable networks, including HGTV and the Food Network; the market now values this business more than $5 billion.

If Fairfax is to survive, it too must cease thinking of itself as a newspaper with online content that complements it. It must rethink its current focus on being paid for online content and concentrate instead on delivering timely and relevant information and entertainment through new media to its most important asset: its readers.

But where EW Scripps differs from Fairfax is revealed in the fact that EW Scripps started new media businesses. Fairfax, on the other hand, has diminished some of its intrinsic value by acquiring new media businesses, arguably at prices that were not justified by their subsequent performance.

As a fund manager I will leave commentary about the execution of Fairfax's online media strategy to those who are expert in such matters. What I can comment on is the current performance of the business, the irrational book value of its intangible assets and its intrinsic value. For me, these are the things that are relevant in determining whether it is worth buying a leaky boat in the expectation that a new skipper can repair it before it sinks.

Fairfax's reported profit before abnormals of $217 million for 2009 is less than the profit reported five years ago and has grown by less than 3% over the past nine years. This latter statistic suggests, even without looking at the share price, that after inflation Fairfax owners have gone backwards.

Even more concerning is the decline in return on equity from 15.5% in 2000 to 4.6% this year. If 4.6% seems exciting for you, there are plenty of bank deposits on offer through which such salubrious returns are available at much less risk. Corbett has his work cut out.

Such a low rate of return on equity indicates that the assets and in particular, the $3.6 billion of intangibles and $2.3 billion of accounting goodwill are unsustainably overvalued on the balance sheet. If return on equity does not improve substantially, the auditors must surely ask how they can justify such high valuations.

Combined with a new chairman, it raises the prospect of further impairments to goodwill. This is a euphemism for “Whoops, I paid too much” and while the item — $543 million in the current year — is treated by many as an abnormal, it isn’t, if there is more to come. Even more risk.

Finally, it is worth noting that investors have injected $4 billion into the business, on top of the $600 million the company had a decade or so ago. Moreover, the number of shares on issue have also increased from less than 800 million to 2.4 billion. In total, investors have put in and left in $3.8 billion over the past decade and yet the total market value of the company is only $200 million more.

I said earlier that I didn’t even need to look at the share price to know investors have gone backwards. This last piece of information shows conclusively that they have. Investment returns are indeed a function of the business boat you get into. The latest skipper, Roger Corbett, is going have to row mighty hard and with a “titanic” weight on his shoulders.

Roger Montgomery is an independent analyst and managing director at rogermontgomery.com and writes regularly for Eureka Report