Getting in shape to face 2015

by Roger Montgomery

Key points

- *Companies need to get serious after a decade of enjoying demand from a resource-hungry China.*
- *Just cutting the fat won't do it, companies also need to focus on strategy and innovation.*
- *Companies like Seek, Ramsay and Challenger have had good foresight.*

A Happy New Year to everyone from the team at Montgomery. For many returning from the festive break, the focus will be on removing the excess that has crept in over time. But I'm not referring to those of you who overindulged in ham and Christmas pudding this year. I'm talking about the job at hand for managers of Australian companies.

Cutting the fat

For the past decade, Australian companies have enjoyed the side-benefits from a resource-hungry China. When times are good, management tends to focus on winning work rather than minimising expenses. Once the work is secure, the focus should revert to maximising earnings through efficient operations. But if a boom continues for a prolonged period, there is less pressure to target efficiencies and excesses easily develop. Now that the party has ended, many corporate giants have woken up, looked in the mirror, and realised that they need to shape up. And fast.

Take **Coca-Cola Amatil (ASX: CCL)** for example. Between 2006 and 2013, revenue grew at an average 4.3% per annum, of which 3% was derived from price increases. When volumes declined in 2013 as a result of pressure from supermarkets and increasing competition, Coca-Cola was forced to lower prices in response. Margins at the EBIT line (earnings before interest and tax) subsequently fell from 19.2% to 16.6% in the first half of 2014, which suggests that efficiency may not have been a top priority of management.

Coca-Cola isn't the only major Australian company that has gone to the fridge and thrown out all the junk food. Qantas, Brambles, AMP, Fairfax, BHP Billiton, Rio Tinto, Boral and QBE all embarked on cost reduction programs in 2014.

Deutsche Bank considers that this may be just the beginning of a multi-year cost-out effort. Australian equities outperformed US equities during 2003-2007 by 76%, and due to the "China effect" experienced a shallower downturn in 2009. For a number of years, companies in the United States have been forced to reduce expenses in order to grow earnings.

Fit and fast

But anyone who has needed to get back into shape knows, that the real work begins when the feet hit the pavement. In order to grow earnings sustainably, companies must innovate and reinvest at higher returns. The gains will come, but it will not be as quick as a cost-out program, particularly if innovation has not been a higher priority for a prolonged period.

We expect that **Coles (ASX: WES)** and **Woolworths (ASX: WOW)** will soon awake to this harsh reality. By enjoying a comfortable duopoly for many years, Coles and Woolworths have grown earnings by focusing on sales, rather than eliminating internal costs. Contrast this to Aldi, the German discount supermarket chain, whose sole focus is to provide customers with relatively fewer, high quality items at the lowest possible prices. Since opening its first Australian store in 2001, Aldi has built its network to 350 supermarkets and now has sufficient scale to challenge the incumbents.

Readers only need to look at **Metcash (ASX: MTS)**, operator of the IGA network, to appreciate the consequences of failing to innovate. In 2014, Metcash announced a transformation plan, which requires hundreds of millions of dollars to refurbish stores and overhaul its supply chain. The company was forced to slash its dividend to pay for these initiatives, and its share price ended the year 40% lower.

The poster children

But this should not spell doom and gloom for investors. In fact, there are many listed Australian companies that have used the past 10 years as a platform for future growth.

Challenger Financial (ASX: CGF) spent this time defining the annuities market, and is now very well positioned for rapid growth from an ageing population seeking secure retirement income.

Ramsay Health Care (ASX: RHC) ventured offshore to become one of the largest, and most profitable, private hospital operators in the world.

Sirtex Medical (ASX: SRX) has taken the time to prove the potential of its highly innovative product, Sir-Spheres, to combat liver cancer.

Seek Ltd (ASX: SEK), Australia's largest employment classifieds website, is trying to replicate its domestic success by investing in leading job boards around the world.

Montgomery Investment Management has invested in these companies; they are able to redeploy capital at high rates of returns, borne from a continual focus on innovation. If you invest in companies, which have the same philosophy, then your portfolio should be in very good shape.

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