'These talks are trivial'

Retail Food defends silence over $160m pitch

DEREK ROSE
FOOD

THE company behind chains including Donut King and Brumby's Bakery has defended how it disclosed details of a refinancing proposal, saying it did not believe the information was market sensitive.

Retail Food Group says it does not believe details of a $160 million recapitalisation proposal from a Hong Kong investment company would have had a "material effect" on the price of its shares.

On Monday, the company received a "please explain" from the Australian Securities Exchange after its shares surged, having also spiked last Friday.

They rallied 57.1 per cent over the two trading sessions, adding $14.6 million to the market value of the group, which also owns brands including Gloria Jean's Coffees and Michel's Patisserie.

Retail Food responded to a price query from the ASX by saying it didn't know of any undisclosed information that could explain the surge.

Late the next day, it confirmed a report it was in "advanced" discussions with Soliton Capital Partners to refinance the company and pay down its $260 million debt.

It also said it was in advanced discussions related to the sale of one of its "non-core assets", without providing details of that asset, but added there was no guarantee an agreement would be reached.

On Wednesday, the Australian Securities and Investments Commission said it would review whether Retail Food breached continuous disclosure rules, which require listed companies to immediately announce any information that might materially affect their share price.

The ASX also sent the company another "please explain" note.

In responding to that query, Retail Food said it did not think Soliton's non-binding proposal "to be information that a reasonable person would expect to have a material effect on the price or value of its securities".

The company noted it had previously announced to the market it was exploring a range of options to reduce debt, including asset sales and equity funding methods.

"Given the indicative and non-binding nature of the proposal received from Soliton Capital Partners, in RFG's view, there is no new material information contained in the information."

Retail Food shares fell 6.8 per cent, or 1.5c, yesterday to 20.5c.

AAP

Frequent flyer backer seeks exit

AVIATION

VIRGIN Australia says the fund manager that bought a stake in its frequent flyer program five years ago is looking to offload its 35 per cent interest.

Affinity Equity Partners, which paid $336 million for the Velocity Frequent Flyer stake in August 2014, has requested "various exit options", the airline said yesterday.

Virgin said the carrier remained committed to the long-term growth of Velocity, which had 9.1 million members at the end of last financial year.

That was up from 4.5 million when the Affinity deal was announced.

Velocity had the healthiest earnings margin by far of any of Virgin's businesses over the year to June 2018.

But the margin still declined as earnings from the program fell 22.9 per cent to $110.1 million following regulatory changes to Australia's credit card industry.

In 2017, the Reserve Bank introduced a cap on domestic credit card interchange fees, which limited fees banks could charge to businesses to process credit card payments.

One knock-on effect was that many businesses reduced the number of frequent flyer points they offered their customers.

Virgin shares fell 2.9 per cent, or 0.5c, yesterday to 16.5c.

Shares in the airline have fallen more than 40 per cent over the past 18 months.

FEAR OF FAILURE A BARRIER TO SUCCESS

PATRICK TADROS
SMALL BUSINESS

ONE in five Australian small business owners are afraid to take chances in order to get ahead, polling indicates.

According to a survey of business owners, 20 per cent are risk averse and say they never take risks.

Eighty per cent said they needed to take risks and some saw it as an everyday part of running small businesses.

The survey was commissioned by Officeworks in partnership with the *Herald Sun*.

Council of Small Business of Australia executive director Peter Strong said some of the risks facing many of the people who ran small business revolved around trust.

"Small business owners tend to sign leases and franchise agreements without reading the fine print or getting advice," Mr Strong said.

"This can lead into difficult situations and bankruptcies.

"Employing others is another risk as owners are trusting people with inventory, passwords and customer details."

Mr Strong said although that could create pitfalls for small businesses, there were also benefits.

Among them, they could react faster to market needs, he said.

"Small business owners are more agile to react to change than large businesses, who need to form committees and consult boards," Mr Strong said.

Philip Pryor, founder of consultancy service Family Business Central, said that without taking measured or considered risks, success for small businesses was unlikely.

"The reality in business is that things are always changing with new products and approaches," Mr Pryor said.

"If you are staying with the 'same old, same old', people can get bored.

"In family businesses, the sweet spot is taking fresh ideas of the next generation coming in and combining it with the hard-learned wisdom of the current generation.

"This produces new opportunities while hopefully avoiding some of the disasters of the past."

When seemingly bad news might actually be good news

THE SHORT CUT
ANDREW MACKEN

AT an investor day in Sydney last month the newly-appointed chief of Challenger, Richard Howes, announced something any new CEO would rather not.

Howes announced he was abandoning the 18 per cent pre-tax group normalised return on equity (ROE) target that had been held by the company for the past 15 years.

The market did not take kindly to this news, wiping off 16 per cent of Challenger's market capitalisation over the subsequent 24 hours.

But it is worth digging into this change made by Challenger's management team more deeply.

You see, Howes did not simply abandon the prior 18 per cent ROE target; he instead replaced it with a formulaic target that incorporates the RBA cash rate. That is, Challenger now targets a group normalised ROE of the RBA cash rate plus 14 per cent, pre-tax.

Said another way, if the RBA cash rate is high, for example at 5.25 per cent in 2004 when Challenger's original 18 per cent ROE target was set, then Challenger's new ROE target would be 19.25 per cent.

Whereas, if the RBA cash rate is relatively low, for example at 1 per cent today, then Challenger's new ROE target is 15 per cent.

Given the nature of Challenger's business, this new formulaic structure for the ROE target is reasonable.

After all, the earnings generated by Challenger's life business — which drives the vast majority of the company's total earnings — is derived from two broad components:

1) The interest earned on the shareholder capital that is required by regulators to be held; and

2) The spreads, or risk premiums, that can be harvested by the company on its book of life business.

In a low interest rate world, the former would obviously be lower — and sometimes the latter too.

Of course, lower earnings are generally considered to be a bad thing by investors, all else being equal.

But all else is not equal. If earnings are lower only because interest rates are lower, then it also implies an investor's opportunity cost is also lower.

This is a concept in finance theory that basically compares the ROE that is generated by a business to an investor's best alternative return that could be generated by taking the same degree of systematic risk.

This opportunity cost is often referred to in industry jargon as the "cost of equity".

Here is how to think about it. If Challenger's cost of equity is, say 10.5 per cent, and it generates an ROE of say, 14 per cent, then it has created value.

If it generates an ROE of 10.5 per cent, then it has neither created nor destroyed value. And if it generates an ROE of less than 10.5 per cent, then it has destroyed value.

When Challenger announced a lower ROE target, the stock price reaction arguably implied the reduction in ROE was not accompanied by a commensurate reduction in the firm's cost of equity.

This cannot be true. The company's cost of equity must be lower as the RBA cash rate falls. And a lower cost of equity, said another way, equates to a higher fair price-to-earnings multiple, all else being equal.

At Challenger's investor day in Sydney, Richard Howes stated he believed the business would generate an ROE well above the company's cost of equity. And here is where the finance theory gets really interesting.

If a business can generate the same excess return over and above its cost of equity under all conditions, then this business should actually be more valuable in a world in which the cost of equity is lower, notwithstanding the lower company earnings.

Food for thought.

ANDREW MACKEN IS CHIEF INVESTMENT OFFICER AT MONTAKA GLOBAL INVESTMENTS