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PERSPECTIVES

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# DON'T NORMALISE THE NORM

## OVERCORRECTING FOR UNDERPERFORMANCE

Normalisation is an important part of business reporting and valuation. It allows analysts to form a better judgement on how a business is likely to perform going forward, ensuring that historical growth rates, returns and profitability measures are not skewed by white noise aka 'one off' items. But often the term 'one off' is used as a catch all, used simply to soften the blow of a bad result: Is it a 'one off' event for a mining company to experience regulatory hurdles? Is it a 'one off' event for a real estate business to experience property value fluctuations? Is it a 'one off' event for an agricultural business to experience bad weather? We think not. In fact, for many companies, the most unusual thing is when there are no disruptions to business plans at all.

**1. What is normal?**
Our analysis shows that over 80% of ASX 300 companies did not have a 'normal' year last year. That is, over 80% of companies reported a cost and/or profit item that was highlighted as a 'one off' item. And this practice is a regular occurrence. We've worked back through the data from Capital IQ and for every year since 2009, over 70% of ASX 300 companies have reported one off items. In fact, 30% of current ASX 300 businesses that were ASX 300 businesses in 2001 have reported unusual items every year since then. Unusual items are clearly part of doing business.

In doing this analysis, it is easy to be caught out by survivor bias – of course today's ASX 300 index doesn't include all the companies that have fallen out of the index over the years, and thus is positively skewed. But even if you strip out this bias, at least 70% of companies have reported an unusual item every year since 2005.

Of course in part this is due to accounting standards, which have encouraged greater transparency of one off items over the years. Cynics will, however, be pleased to hear that unsurprisingly one off items are more often than not negative items. For all ASX 300 businesses that reported unusual items in the past 12 years, companies have on average reported one off losses of over $40m a year. And again, if you remove the survivor bias, and look only at businesses that have achieved over $100m revenue consistently across the past 12 years, the one off losses that have been reported have averaged over $90m a year. So maybe companies have more negative surprises than positive ones. Or is there just a natural human bias to modest optimism?

Over 80% of ASX 300 companies reported one off items last year

**2. Expect the unexpected**
What does this mean for assessing business performance? We've long favoured basing industry peer comparisons on raw data, with minimal adjustment for items reported as one off or otherwise unusual. This analysis demonstrates clearly that this approach is more reliable than simply ignoring the one off items. Importantly, this means that valuation multiples – which are generally quoted after adjusting for unusual items – are often reported below where they should be.

What happens if there are no unusual items? If everything goes according to plan, the result should really be normalised *downwards* to account for the fact that one off items did not occur. The mining business that did not suffer a hedging loss for the first time in three years, the primary production business that grew and sold its entire forecast crop, the highly acquisitive organisation that did not have any restructuring costs during a year of buying and selling businesses are all unusual. So we should make appropriate allowance for this too.

**3. The future will be unusual too**
Looking to the future, companies and external parties are constantly making forecasts about future cash flow expectations: *'Assuming the business runs smoothly, we expect the following results...'*. This happens publicly through earnings guidance, and more importantly, these assumptions are baked into every internal corporate or government forecast. However, as discussed above, assuming that the base case will be delivered may be a dangerous assumption. Businesses do not run smoothly. If corporate reporting history is to be believed, more often than not there are write downs, impairments, restructuring costs, losses on business sales, losses on investments – and the list goes on. On average, ASX 300 businesses experience one off losses that average $25m every year (equal to around 1% of sales revenue).

So one off items are actually pretty reliable and it is normal to have them. As a result, they should be factored into near to medium term financial projections. But how often do you see this happen? Often there may be a level of caution in forecasting, particularly if the forecaster is being held accountable for the result, but in truth very few corporate forecasts include an average one off item. There's statistical evidence that old-fashioned contingencies should be explicitly included every year.

More broadly, many articles have been written about the asymmetric impact of news on financial markets. Investment markets respond more harshly to bad news than they do to good news. So here's the point. By not talking more explicitly about the potential for negative one off items year by year, businesses may be setting themselves up for earnings forecast downgrades, which often will have disproportionately negative impacts on share prices. As we explored a few months ago in "Groaning or Growing?", this increases volatility and uncertainty, and so can destroy value.

Businesses and governments like the certainty of base case forecasts and projections, shying away from messages that talk about variables outside their control. We think that it is better to accept the fact that one off events will continue to occur. You should make allowance for these one offs – and should talk about them fearlessly in public. You'll show from the start that you are prepared for the bumps in the road. This is much more than just 'under-promising and over-delivering'. It's about embracing uncertainty and discussing it openly. If you do, over time you will encourage investors, commentators and voters to think differently about risk and variation, reducing the negative impact of one off costs and refocus attention on what really matters – long term performance. P

***By Daniel Chaitow***
***and Nigel Lake***

## About Pottinger

Our clients say that we offer a completely different proposition to traditional consulting and investment banking advisors, seamlessly integrating true strategic thinking, commercial insight, financial expertise and execution excellence. Our assignments typically relate to one or more of:

- Strategy and public policy
- Mergers and acquisitions
- Partnerships and joint ventures
- Restructuring and capital advice
- Risk, sustainability and related decision-making

Our approach to every assignment reflects a fundamental belief that strategy, business and execution perspectives must underpin any business initiative if it is to be commercially successful and stand the test of time.

Together our team has advised on over 200 M&A and financing transactions, as well as many significant strategic advisory assignments. Our first hand experience covers most of the world's larger economies, and we are accustomed to working on complex assignments across borders and cultures.

We are highly regarded for our investment in people, most recently being profiled by the Australian Workforce and Productivity Agency as a role model for effective skills development in financial services. In addition, Pottinger is the only organisation ever to have won the ABA's "Recommended Employer" award for six years in a row.

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If you believe the current vibe in the newspapers, then a Coalition win at the 2013 Federal Election is a foregone conclusion and the ALP faces electoral annihilation. With inspiration from the success of electoral statisticians such as Nate Silver in the US, we decided to investigate the upcoming election using the statistical armament at our disposal. The conclusion: although the ALP is undoubtedly in trouble, there is still the possibility of a significant ALP recovery (enough to win the election), and the ALP vote is unlikely to get worse from where it currently stands. A modest degree of ALP recovery before the election is the most likely outcome.

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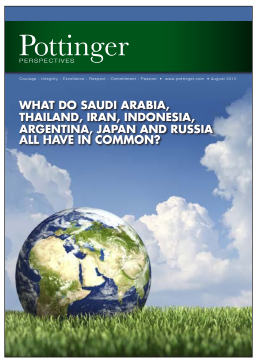


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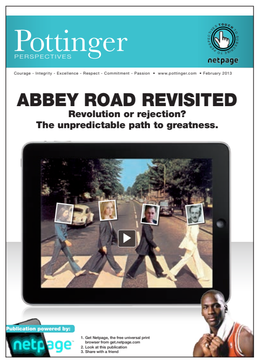


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