

FINANCE & TREASURY

LOW-DEBT COMPANIES

Cashed-up heroes

Not all Australian companies are suffering under the weight of debt. Plenty are thriving without leverage, as MAGGIE MACRAE discovers.

FOR EVERY high-profile player buckling under the weight of debt and an inability to secure funds, there are a host of cashed-up companies with low debt, or none at all, quietly going about their business.

These include companies such as Australian Wealth Management, Flight Centre, Infomedia, Mortgage Choice, Platinum Asset Management, Servcorp, Treasury Group and Washington H Soul Pattinson. Critics may dub them cautious or boring, but experts say they are shining examples of capitalism at its best and most basic.

An associate professor of economics and finance at the University of Western Sydney, Steve Keen, says these companies – and others like them – stand in stark contrast to the debt-laden, complexly structured enterprises that have dominated the headlines for all the wrong reasons in recent times.

Keen says the irresponsible use of debt by a minority of companies has given debt a bad name for the majority. "Using debt to fund innovation, for example, is good use of debt," he says, "but too much of recent debt is used in wasteful ways, such as speculation, and this wipes out real enterprise."

Finance experts and chief financial officers say establishing, developing and running low-debt, cashed-up companies is not based on rocket science. Rather, they say, it is about common sense, sound strategies and basic finance and operating structures. However, they add that successful models and finance policies must be tailored for each company.

The chief financial officer of national mortgage broker Mortgage Choice, Tony Crossley, says it was through trial and error

that the founders of his company came up with their successful model and finance policies in 1992. The result was a pure play distribution model and a national franchise network, featuring cash flow as the ultimate funding source.

The company's founders used equity, rather than debt, to establish the business and continued to use it until the end of 2000, when they supplemented it with a low level of debt that was repaid within two years. Crossley says swings in consumer sentiment and activity that occurred in short time frames posed significant risks to using debt for expansion, especially early in the business' history.

OUTSOURCING RISKS

Mortgage Choice, which listed in 2004, has had no debt for the past six years. Crossley says this is a function of its business model, finance policies and corporate maturity. "A good franchiser can run with minimal debt because it has outsourced the management of many business risks, such as debt, to its franchise network," he says.

"We derive a level of recurring income for following up on past activity. We receive a level of income from our loan book with which to service customers. This loan book grows each year. [By the end of 2001] we had generated sufficient recurring income to finance our business needs.

"As a mortgage broker, we [also] deal in debt. A job well done for us means we have matched our customers with appropriate levels of debt that have been structured with the right combination of features and pricing for the customer. Borrowing at the corporate level



TONY CROSSLEY

Tony Crossley, Mortgage Choice: Our business model means we have had no debt for six years.

heaps business debt risk upon an underlying exposure to debt markets, in effect, amplifying the risk."

The company's business model and finance policies have seen its loan book jump from \$4.2 billion in 2000 to more than \$33 billion in 2008, and Mortgage Choice consistently delivers good profits and attractive yields. In 2007-08, it reported revenue of \$161.4 million, profit of \$19.3 million, net cash of \$8.5 million, \$55 million in equity and no debt.

Unlike Mortgage Choice, office space and information and communications technology (ICT) developer and provider Servcorp has just recently added franchising to its business and

it has introduced it only in India. CFO Tom Wallace says it prefers the cookie-cutter model that has proved so successful for the company locally and internationally.

Servcorp, like Mortgage Choice, has a business model that has generated impressive ongoing cash flow since its formation in 1978 – buying office space and renting it out. In recent times, it also has begun developing ICT systems and offering them to customers. Wallace says its finance policies are: organic growth at a rate that its resources and management can handle without sacrificing quality, minimal risk, no debt is best and cash for growth. "The only leveraging we do is of our own expertise and

skills," he says. "In the time I have been here, we have always used cash."

Wallace says it has also been Servcorp's policy to build a cash buffer as insurance for tough times. "The tough times are here now," he says. "We have already successfully survived three or four economic downturns in our history, so we know our business model and our finance policies work very well."

Its model and policies have seen the company, which listed in 1999, boost its total floors from 47 in 2004 to 71 in 2008, increase its revenue from \$104.2 million in 2004 to \$190.1 million in 2008 and raise its cash levels from \$54 million in 2007 to



\$74 million in 2008. As of June 30, it had a paltry \$270,000 of debt.

COMMON TRAITS

The managing director of *The Intelligent Investor*, Steve Johnson, says there are common traits for low-debt, cashed-up companies.

Besides those already mentioned, these include having founders and their families or majority shareholders as long-term senior executives, difficulty in obtaining funds at their start or early in their history and an ongoing focus on core business. "In recent years, some companies have also been the unsuccessful targets of private equity firms," Johnson says.

Flight Centre, in particular, ticks all of the boxes, including unsuccessfully flirting with private equity. Shannon O'Brien is CFO of

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TOM WALLACE, SERVCORP

the 27-year-old Brisbane-based listed travel and events group. He says the company, like Mortgage Choice and Servcorp, has a historically conservative attitude towards debt and relies on its strong cash flow to fund growth.

"[We also] operate in a heavily regulated environment," O'Brien says. "Regulations

that are in place in Australia and in some of our overseas jurisdictions, in effect, prevent travel agents from taking on what many would perceive to be a fairly conservative level of debt."

It was uncharacteristic, therefore, in 2006-07 when Flight Centre opted for a highly leveraged structure involving private

equity partners to finance the next stage of its corporate development. One deal was a Pacific Equity Partners-backed, \$17-a-share management buy-out to take the company private, and the other was a joint venture. Flight Centre's shareholders rejected both.

Ironically, the rejections proved to be a boon. Since then, the company's shares have, at times, traded well above \$30 and it has reported high revenue and profit growth. It made six acquisitions and investments worth almost \$170 million in 2007-08, including the company's largest to date, the \$152 million purchase of United States-based Liberty Travel.

As of June 30, Flight Centre had cash and cash equivalents of \$182.8 million and bank debt of \$160.6 million, of which \$60 million was for the Liberty purchase and \$30 million

for buying property. Although this is the most debt the company has carried, experts are not concerned, as they say it is still a low level for a business of Flight Centre's size and cash flow.

At many low-debt companies, founders and their families are heavily involved in the ownership and/or management of the businesses. This is particularly apparent at Servcorp and century-old diversified financials group Washington H Soul Pattinson. Servcorp was founded by Alf Moufarrige, who remains chief executive. His son, Taine, is an executive director and responsible for operations in Australasia and the Middle East. Another son, Marcus, is chief information officer. At WHSP, founder Lewy Pattinson's great-grandson, Robert Millner, is chairman, Robert's cousin, Michael Millner, is deputy chairman and a cousin via marriage, Peter Robinson, is a director.

SHOWERED WITH MONEY

Like many of its counterparts, Servcorp had difficulty securing funding during its infancy. CFO Wallace says banks and financiers would not even meet with its executives to discuss funding, let alone provide a line of credit. How times have changed. "Since we have been cashed-up, banks especially have been throwing themselves at us and wanting to shower us with money," he says.

It's worth noting that even companies with no debt recognise that borrowing has its uses. Crossley says Mortgage Choice will "absolutely consider" reasonable levels of debt when the circumstances warrant it. "The lesson of recent history is that using debt to finance sustainable growth is sensible and probably essential," he says. "Using it to fund unsustainable growth is futile and doomed. The whole art is determining that sustainability."

Despite the regulatory environment under which it operates, O'Brien says Flight Centre still has room to move on debt. He says the company will consider a moderate level of further debt at an opportune time to fund growth and create additional value. Not surprisingly, leveraging is not an option. He says the company will consider bank debt only with a medium- to long-term position and in a conservative way that will maintain its investment grading.

But unlike Flight Centre and Mortgage Choice, Servcorp is not about to consider taking on any debt any time soon. "For us, good debt is no debt," Wallace says. "I am really happy with the position we are in. I am not worried about debt at all and I love not having to spend any of my time working out how to please bankers." *