



PLATINUM CAPITAL LIMITED

ACN 063 975 431

# Quarterly Report

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# Performance

There has been little momentum on the upside this quarter nor indeed for the year to date. The weakness of the Euro and the steep lift in the oil price have dented investor optimism and brought into question the level of valuation of high growth stocks. There has been a systematic shuffling of the pack with the dot coms being the first to fade in December / January (prices are now down by up to 90%); this was followed by the telcos and subsequently by the telco equipment suppliers by around July. Now we are starting to see the "untouchables" doubted such as Oracle, EMC, Siebel: the consequence of this is that the Nasdaq has fallen by 11% year to date (-7% for the quarter in US\$) and with it the likes of the

Neuer Markt, Kosdaq index etc. The broader markets have not suffered the same destruction on account of rotation into hitherto dull areas like utilities and financials. As a consequence, the overall MSCI World Index is up 12% year to date (+5% for the quarter).

Platinum has benefited from its early migration away from TMT (telecoms, media and technology) and from adding to existing low valuation plays. There have also been trading successes through shorting Intel, Nokia, Cisco and others. Offsetting the good work has been the hedging of some assets into A\$ and Euro.

Overall, management's stock picking has proved beneficial reflected in a 6.5% growth in pre-tax asset value over the quarter and 12.9% for the year to date.

The following Net Asset Value figures are after provision for tax on both realised and unrealised income and gains.

NET ASSET VALUE	
31 July 2000*	152.40
31 August 2000*	156.70
30 September 2000*	160.03
* This is before making provision for the 8 cent final dividend paid 14.11.00.	

# Changes to the Portfolio

There has been little thematic change in the portfolio. In Japan we reduced our exposure to domestically sensitive companies like house building and coke bottlers. We added Mitsui OSK, the world's largest owner of oil tankers and natural gas carriers, the valuation of which remains depressed unlike its competitors in Europe whose stock prices have surged.

In the US, we added to Ambac (credit insurance) and bought more AMD, Verizon, Lucent, National Semiconductor and Novell after sharp price retracements. Later in the quarter, the doubling in the price of JD Edwards offered a good exit and we used a similar move in the price of Peoplesoft to bring the holding below 5% of the portfolio. Acuson was bid for by Siemens at a 60% premium; Silicon Valley Group was also bid for at a similar premium in early October.

In Europe we sold the remaining Ericsson and Smiths Industries. Toro was bid for at a 40% premium. The only new holding was Adidas-Salomon, which is going through a thorough overhaul. We added selectively to existing positions.

The change in the emphasis of the portfolio is shown below.

BREAKDOWN BY INDUSTRY (%)		
CATEGORIES	EXAMPLES OF STOCKS	SEP 2000
Cyclicals	RMC, Akzo, Bayer, Stinnes, Linde	16
Technology Hardware	Toshiba, Samsung, National Semi, AMD, Fujitsu	13
Telecoms	NTT, DDI, SK Telecom, Lucent	11
Software & Media	Novell, Peoplesoft, Nippon & Tokyo Broadcasting	8
Medical	Acuson, Draegerwerk, Medison, Merck KGaA	8
Consumer Brands	Lotte Confectionary, Japanese Coke Bottlers, Adidas-Salomon	7
Retail/Services/Other	Hornbach, Raytheon, Loewes	7
Financials	Lippo, Japanese Brokers, Nordic Baltic Holdings	6
Consumer Durables	MEI, Citizen Watch, Sony	6

DISPOSITION OF ASSETS (%)		
REGION	SEPTEMBER 2000	JUNE 2000
Western Europe	29.2	26.3
Japan	27.1	31.3
North America	23.3	19.2
Other Asia	5.3	7.1
South America	0.4	0.4
Australia	0.3	0.0
Russia & Eastern Europe	0.1	0.1
CASH	14.3	15.6

The company's short position is 5% against the Nasdaq 100, 19% against the S&P500 and 20% against individual US companies.

# Commentary

**P**riced for perfection has been a frequent description of stock valuations over the last two years. Productivity has certainly improved; inflation has been remarkably subdued, and now with the slowing of the US economy, the threat of more expensive money is in abeyance. However, two imperfections have arisen. The oil price has risen sharply and the weak Euro, which was initially shrugged off, is having unexpected consequences.

The current oil price movement is not far short of the spike experienced during the first shock of 1973. A price of some US\$30 per barrel is nearly three times that of January 1998 and the average oil price for this year will probably be twice that of 1999. The consequence of earlier shocks was to drive the world economy into recession. This time around, the benefits of lower oil dependency, broad technology-led growth, a milder inflationary undertone and a somewhat less panicky consumer response should militate against too dramatic an impact. OPEC is seemingly less belligerent too and has agreed to bolster its production by a total of 3.2 million barrels per day, a rise of over 11%, and equivalent to approximately 4.2% of world consumption. However, because of bottlenecks throughout the supply chain and the desire by some to increase their national strategic reserves (China, Korea and Poland), it looks unlikely that the oil price will recede below \$30 for some time.

That this will have a negative impact on consumer spending is clear. Furthermore, unlike the 1973-74 episode when inflation was prevalent, the ability of firms today to pass on cost increases is much reduced so one must expect compression of companies' profit margins.

The weak Euro is exacerbating these cost pressures as oil is priced in US\$. Since its formation in January 1999, the Euro has depreciated by 25% versus the US currency. European companies are feeling the squeeze through higher prices for fuel, chemicals, plastic packaging etc. For American based multi-nationals there is the added damage of European-sourced profits being translated into fewer US\$. Hence the profit warnings from Gillette, P&G, DuPont et al.

As signs of an economic slow-down become more evident so investors are increasingly sceptical about the growth promised in the valuation of tech and other highly rated stocks. Business computers and peripheral equipment already account for \$60 out of each \$100 spent on durable equipment in the US versus \$10 in 1975. The market may well be readying itself for a reassessment of the further growth in IT spending and, by extension, the valuation of the sector. We believe the earning warnings by Intel, Apple, Dell & Co are precursors of this adjustment.

In their search for new opportunities, investors have rotated into financials and utilities although other areas that have historically proved attractive refuges have not benefited.

Pharmaceuticals are under pressure from Mr Gore's populist promises; consumer goods are suffering from having already achieved the benefits from improved systems and upward pricing drift and now face more difficult times in the face of limited volume growth combined with cost pressures. Retailers are likewise facing a less buoyant future as a result of the legacy of earlier large additions to selling space and a fickle public. Marks & Spencer, the venerable UK-based store group epitomises these problems aggravated by the additional burdens of complacency and arrogance.

Changing shopping patterns are taxing even the more agile groups including Gap and Hennes & Mauritz. After years of continual growth, they are struggling to read consumers' present desires. Adding to their problems is convergence of shopping habits and the frightening prospect of Walmart adding 40 million square feet in 2001 - 8% of its current selling space. For perspective, one million square feet is the equivalent of a good sized regional shopping centre.

Even though there is significant rotation, there is still a massive difference in the valuations between so-called "growth" and "value" stocks. Recent work by Goldman Sachs on their global universe of 1,300 companies shows how the valuation of "growth" stocks has moved up from 22 times earnings in 1991, to 57 times now, while "value" stocks have

remained on PEs of 11 times. Goldman calculates that the "growth" shares are pricing in 15% pa cash flow expansion over the next 15 years compared with a 2% pa rise for the "value" stocks. This differential is at an extreme; the past ten years' earnings record of the "value" universe has been 8% pa, while the "growth" universe has achieved 19% pa.

It would be surprising if the valuation gap doesn't narrow. It is common to hear financial commentators referring to respectable, if unexciting companies, as "dead money". This ignores the fact that it is precisely these companies that are the target of take-over bids. In the last quarter, we have received bids for three of our holdings, Acuson, Silicon Valley Group and Toro simply on the grounds of industrial logic. These bids were pitched at up to 60% above the prevailing market price. This process can be expected to continue as globalisation favours size and reach. On a risk-adjusted basis we would rather place our bets on industrial logic than investment fashion.

Optimists who favour the high valuation segment continue to point to the strong inflows into mutual funds and the evident growth prospects that result from the internet revolution. We have no argument with either of these observations other than to point to supply. Investment bankers have hardly been idle of late, recommending to their clients all manner of schemes that will supposedly unlock shareholder value. Tracking stocks are all the rage but more delicious still is the prospect of listing small in-house technology hot houses in the belief that their listing will unleash an even greater level of animation on the part of shareholders. ☺

# Conclusion

The valuation of shares remains highly dichotomous although reservations are emerging as to the business dynamics and valuations of many high-tech companies. Companies with poorer growth prospects such as chemicals, paper, forest products and construction materials, are back to the levels of 6-8 years ago.

We believe there will be further erosion in the valuation of high growth companies but that there is a large constellation of opportunities in the middle ground. These are generally smaller companies that have the ability to achieve growth and yet are priced to deliver almost none. ☺

## Currency

As noted earlier, we have been poorly placed with regard to the US\$ with our hedges into the A\$ and Euro. However, the arguments we now hear against these currencies, have a vacuous ring. While unable to be precise, their valuations look close to a bottom and when there is a reversal, it could be explosive.

Presently 39% of assets are held in A\$; 37% in the Euro, Pound and Swiss Franc; 1% in Yen and the balance, 14%, in US\$ and related currencies. ☺

## Stock Story

### PEOPLESOFT (US)

Peoplesoft was one of the early providers of software products designed to run on networked PC's (known as a client-server environment) that could be used by large companies

to run their businesses. Peoplesoft built leading positions in human resources and financial applications while competing against companies such as SAP and Oracle. From 1993 to 1998, revenues increased more than twenty fold to over \$1.3 billion.

Two major problems appeared in early 1999. Companies started to cut back on software purchases, having already completed year 2000 remedial work on their IT systems. Then the focus of corporate IT spending moved to the internet and companies became more focused on spending on "outward facing" applications that concentrated on managing customer and supplier relationships rather than internal processes such as human resources. Given this "outward" focus it became necessary to "web-enable" software applications so that they could be accessed over the internet even if they were not loaded on the individual PC (ie. by using a web browser). Peoplesoft, along with the other leading enterprise software companies, saw sales of new products collapse and profits disappear.

In May 1999, Craig Conway joined the company, initially as chief operating officer and then as CEO. Conway's history included eight years at Oracle in senior sales and marketing roles as well as with two successful software start-ups. The critical decision was made to "redesign" all of Peoplesoft's applications completely so that they could be accessed through a web browser. This was a significant effort that required rewriting over 30,000 screens and a research and development investment that absorbed over 25% of revenues during the last year. The other important development was the acquisition of Vantive which was the number two player in customer relationship management (CRM) software, one of the new fast growing areas. The company also partnered with Commerce One to develop e-procurement software used by companies to hook into business

to business electronic exchanges. Peoplesoft continued to develop new applications in areas such as supply chain and analytics.

This effort culminated in the launch of Peoplesoft 8 in July 2000, a suite of web-enabled applications addressing both traditional and new fast growing segments. The company is well positioned versus its traditional competitors who are at the very early stages of re-writing applications for the web or still struggling to enter new areas such as CRM. Versus the many new entrants in the software market, not only does the company have an already profitable and cash-flow positive business, with cash balances in excess of \$600 million, but it also has the advantage of a significant existing and highly satisfied customer base. The last stages of the turnaround are now under way with the company building up its sales force for the launch of Peoplesoft 8.

Platinum initially purchased Peoplesoft during 1999 at prices around \$15. The stock price then ran up with the explosive take-off in technology and telecom stocks only to return to \$15 in the second quarter sell off. By this stage, the "bull case" had become even clearer with the development of Peoplesoft 8 near completion. At this point, Platinum doubled its position in the stock. At \$15 the company was valued at just over twice revenues which are expected to grow at a rate of 30% for at least the next three years. Meanwhile, major competitors such as Oracle are valued at almost 20 times revenue while growing at similar rates (at best). Subsequent to our recent purchases the stock has moved up to over \$30 following increased recognition of the prospects for revenue growth post the launch of Peoplesoft 8.

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