Economic behaviour in the 1980s was distorted by inflation, the effects of capital gains tax, the ignorant misapplication of valuation techniques and deliberate fiddles. The false sense of wealth creation caused by the upswing in the economic cycle and changes in equity and property yield curves was accompanied by the development of "generous" lending practices by financial institutions. Inadequate understanding of valuation principles by valuers and management and inadequate accounting standards compounded the impact of economic forces and the excesses of the entrepreneurial sector. Wayne Lonergan writes that investors (and regulators) must take note of the events of the 1980s and the increasing complexity of financial instruments in the 1990s and take steps to ensure that history does not repeat itself.

The 1980s was a decade of great change in business and financial markets. The second half of the decade witnessed extraordinary corporate excesses which culminated in the sharemarket crash of October 1987. Economic activity and corporate behaviour in the period up to the crash were significantly influenced by inflation and falling property and equity yields. In addition, the 1980s witnessed major changes in the Australian economy, including deregulation, internationalisation and the introduction of capital gains tax.

Persistently high rates of inflation created the perception of rising asset values, particularly in property and equities, and increased the attractiveness of debt. Inflation rates averaged 8 per cent annually over the 1980s. The following example illustrates the effect:

Assume a business earns a net profit of $1 million a year in real terms for 10 years. The compound effect of inflation at 8 per cent a year will create a nominal profit of $2.2 million in year 10 compared with $1 million in year one, yet no real wealth has been created.

Further, during the 1980s there was a significant decrease in property and equity yields or increase in price-earnings ratio (PER) which further inflated asset values. For instance, in September 1987, before the crash, the All-Ordinaries index reflected an average PER of around 21 (see graph, compared with levels around half of this only four years earlier. Accordingly, using the same example:

<table>
<thead>
<tr>
<th>Capital value (m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of equity in a business earning $1 million p.a. using an earnings multiple of 8*</td>
</tr>
<tr>
<td>Value of same equity in 1987 (pre-stockmarket crash) earning $1.7 million p.a. (up $0.7 because of inflation) using an earnings multiple of 21*</td>
</tr>
</tbody>
</table>

Thus, over the period, the combined impact of inflation and falling equity yields created a false perception of an enormous increase in wealth for companies and shareholders. This apparent increase in wealth was, however, not attributable to the efforts and business acumen of investors and management; instead, it was largely (and in some cases entirely) the result of the combined effects of high rates of inflation and declining yields. The apparent increase in wealth during the 1980s further encouraged investment in equities and property, contributed significantly to a perception of man-
agement infallibility, and permitted a minority of directors with questionable business ethics and acumen to attract large amounts of equity and debt capital.

The debt binge

During the 1980s, average ratios of interest-bearing debt to equity increased massively from 39 per cent to 101 per cent (see Graph 2).

Table 1 [(a) and (b)] is a simplified illustration of the effect on the previous example. When equity and property values collapsed, many businesses found themselves with unsustainable debt levels. In some cases the value of equity was entirely eliminated.

Further, a substantial proportion of the increase in value of business assets was attributable to intangible assets (e.g., goodwill). If we take the relatively conservative assumption that the value of all business assets (other than goodwill) increased in line with inflation, and that the value of the business in 1980 included no goodwill, then the notional balance sheet before the 1987 crash would include a substantial element of intangible assets, as is shown in Table 1 (c).

Deregulation

The 1980s saw the deregulation of the Australian capital markets and, in particular, of the banking sector. A substantial inflow of capital into the Australian economy resulted.

Further, the lifting of controls on interest rates and exchange rates, the floating of the Australian dollar, the relaxation of foreign investment regulations and the removal of fixed brokerage commissions substantially increased competition in the financial sector. A variety of new financial products evolved, enabling financial institutions to operate as "financial supermarkets". Numerous cash-management funds and equity and property trusts appeared in the early 1980s. Insurance bonds, the Euro-Australian dollar bond, interest-rate and currency swaps, hybrid debt-equity instruments and financial futures were all growth products during the 1980s.

Greater internationalisation also contributed to the flow of capital into the Australian equities market. Many companies established offshore enterprises as part of their natural growth, as a tax-planning measure or to facilitate more creative financial transactions.

Property values

As with the equity market, the 1980s witnessed a massive increase in property values and their subsequent dramatic collapse. Key factors which contributed to the increase in property values were:

- inflation;
- falling property yields;
- the introduction of capital gains tax;
- distortion of the supply-and-demand dynamics; and
- errors in, and a misunderstanding of, proper valuation methodology.

Inflation: The high level of inflation in the 1980s created a false perception of an increase in wealth as property values rose. The scale of this increase in values is shown in the following example:

Assume a fully-let prime city building with net annual rental income of $10 million and a capital value of $125 million (i.e., 8 per cent yield) in the early 1980s. Its rental income would have more than doubled by the late 1980s through the effect of inflation alone. At the same yield its "value"
Table 1: Effect of debt-to-equity change

<table>
<thead>
<tr>
<th>Description</th>
<th>Equity</th>
<th>Debt (101%)</th>
<th>Value of business assets</th>
<th>Value of other assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Notional balance sheet (1980)</td>
<td></td>
<td></td>
<td>$8.0</td>
<td>$11.1</td>
</tr>
<tr>
<td>*Debt (39%)</td>
<td></td>
<td></td>
<td>$3.1</td>
<td>$11.1</td>
</tr>
<tr>
<td>(b) Notional balance sheet (pre-crash 1987)</td>
<td></td>
<td></td>
<td>$36.0</td>
<td>$39.1</td>
</tr>
<tr>
<td>*Debt (101%)</td>
<td></td>
<td></td>
<td>$36.4</td>
<td>$33.3**</td>
</tr>
<tr>
<td>*Interest-bearing debt (non-interest-bearing debt has been ignored for sake of simplicity)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>**Assuming increase in debt used to finance purchase of other assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Notional balance sheet (pre-crash 1987)</td>
<td></td>
<td></td>
<td>$36.0</td>
<td>$19.1</td>
</tr>
<tr>
<td>Debt (101%)</td>
<td></td>
<td></td>
<td>$36.4</td>
<td>$20.0</td>
</tr>
<tr>
<td>*Assuming intangibles represent the same proportion of newly acquired assets as of existing assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Fall in yields: At the height of the property boom, yields on prime property fell from around 8 per cent to below 5 per cent. As the yields fell, property values increased significantly. The market value of the above property would have risen as a result of the combination of inflation and falling property yields to about $400 million, an increase of 220 per cent.

Property investment attracted large amounts of capital in the physical market and through property trusts as investors became more interested in the potential capital gains than in the cashflow-generating ability of the properties. (Or the lack of it!)

As an indication of how dependent investors became on capital growth, rental yields for most of the 1980s were less than half those prevailing on fixed-interest securities (and for a while they were closer to one-third).

Capital gains tax (CGT): A practice common among property investors and builders in the early 1980s was “pyramiding”: an investor or builder would purchase or build a property for, say, $100 million and fund this by borrowing, say, 80 per cent of the property value. After a period the investor would sell the property at a market value of $200 million (a profit of $100 million) and purchase or build two properties at a total value of $400 million, funded partly through the sale of the first property and partly through further borrowings. The pyramid would continue.

However, with the introduction of CGT in 1985, investors, instead of selling their buildings to fund further acquisitions and constructions, held on to the properties to preserve the value of their CGT-exempt status. They then funded their subsequent acquisitions and constructions through borrowings made against this enhanced value. The effect was to decrease the availability of properties at a time when demand for them was rising, thereby increasing their value and further encouraging owners to hold on to buildings in anticipation of even greater capital gains.

Ironically, the benefits in terms of government revenue obtained by the introduction of CGT hardly compensated for the distortions of the capital markets created by this cycle. Table 2 shows the total CGT collected since the inception of the tax. The relatively low amount collected should be further reduced by tax that would have been collected anyway as “income from profit-making undertakings and schemes”.

Rent guarantees: Another practice that became common in the 1980s was that of “rent guaranteeing”, where a developer would construct a building for $100 million and sell it, unencumbered, to a property investor for, say, $150 million. The developer would invest this amount at interest of 15 per cent a year and at the same time provide a rent guarantee of 7 per cent to the property investor. Assuming, for the sake of simplicity, that the property was funded by equity, the developer would have made a “capital gain” of $50 million ($150 million less costs of $100 million) and annual income of 8 per cent (15 per cent interest income on $150 million less 7 per cent rent guarantee paid to the investor). The property developer would then con-
struct another property and repeat the transaction.

Deals of this sort occurred despite the lack of real cashflow-generating ability of the properties as investors concentrated on making capital profits. The practice of rent guarantees encouraged the excessive construction of property and exacerbated the impact of the subsequent inevitable crash in property values.

**Fit-out costs:** There was also a general misunderstanding (and, in some cases, deliberate fiddling) of the real economic effect of guaranteed rentals, fit-out allowances and rent-free periods. Table 3 illustrates the effect:

**Impact of errors:** As property yields fell, the impact of even a relatively small “error” (or “fiddling”) in a property valuation had a dramatic effect. For example, Table 4 shows the impact of an error in the value of a $100 million property.

**Other valuation problems:** Apart from the effect of general economic conditions on property values, other significant valuation-related problems distorted the market. These problems included:
- lack of competence;
- conflict of interest of valuers with “in-house” selling activities;
- valuations based on specific (undisclosed and sometimes unrealistic) client instructions;
- valuer’s remuneration based on assessed value of property;
- “skulduggery” (or, at best, unbelievable naivety).

**How the system let it happen**

The development of accounting standards throughout the world has, until recently, been reactive rather than proactive. In Australia, deficiencies in applicable accounting standards, and the widespread avoidance of existing standards, contributed to the boom-and-bust cycle. In particular, Australian accounting standards allowed companies to:
- internally revalue upwards their non-current assets (eg, properties, brandnames, mastheads, etc);
- effectively classify as non-depreciable identifiable intangible assets (eg, licences, brandnames and trademarks) what was, in economic substance, depreciable goodwill;
- continue to carry in their accounts overstated asset values on the (unlikely) grounds that “no permanent diminution in value had occurred”; and
- ignore net present value in assessing the recoverable value of their non-current assets.

In essence, accounting standards enabled companies to recognise the good news in an economic upswing and ignore the bad news when the inevitable economic downturn occurred.

To make matters worse, Section 294 (4) of the Corporations Law and its predecessor, Section 269 (7) (c) of the Companies Code did not require that the diminution in asset values be written down (in theory, diminution should at least have been disclosed by way of note). To make matters worse there was, and still is, no specific company law requirement to assess such asset values on a net present value basis.

**The commercial reality**

It is interesting that even lenders, the essence of whose business is borrowing and lending at interest, do not (in many cases) value their problem-loan receivables or their property assets at net present value.

It is obvious that on a commercial level a willing but not anxious purchaser of an asset is not going to pay an amount greater than the net present value of the asset’s expected future cashflows. In accordance with the direction that the accounting-standard setters have taken in other areas, it will be necessary to amend the definition of “recoverable amount” in AASB 1010 to make it clear that it is mandatory for the “recoverable amount” to be measured in present-value terms.

Further, as the objective of general-purpose financial reports is to “provide information to users that is useful for making and evaluating decisions about the allocation of scarce resources” (SAC 2 Objective of General Purpose Financial Reporting), then, for

**Table 2: Capital gains tax collections**

<table>
<thead>
<tr>
<th>Income year</th>
<th>Revenue from capital gains tax ($m)</th>
<th>% of total tax collection</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986/87</td>
<td>94</td>
<td>0.12</td>
</tr>
<tr>
<td>1987/88</td>
<td>281</td>
<td>0.34</td>
</tr>
<tr>
<td>1988/89</td>
<td>582</td>
<td>0.64</td>
</tr>
<tr>
<td>1989/90</td>
<td>631</td>
<td>0.68</td>
</tr>
<tr>
<td>1990/91</td>
<td>293</td>
<td>0.33</td>
</tr>
<tr>
<td><strong>1990-1992</strong></td>
<td><strong>1,881</strong></td>
<td><strong>0.37</strong></td>
</tr>
</tbody>
</table>

*No information is available for 1991/92 as taxation returns are still being collected and ATO has not made an estimate*

**Table 3: Effect of fit-out allowance on apparent value**

<table>
<thead>
<tr>
<th>Value ($ per m²)</th>
<th>Nominal rent</th>
<th>Fit-out costs allowed by developer</th>
<th>Real rent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>400</td>
<td>1,500</td>
<td>250</td>
</tr>
</tbody>
</table>

(Note: $1,500 per m² over, say, 10 years equals reduction in true rental value of $150 per m² p.a.)*

<table>
<thead>
<tr>
<th>Nominal value at 5% yield</th>
<th>Real value based on real rent</th>
<th>Overstatement in value</th>
<th>Percentage overstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>8,000</td>
<td>5,000</td>
<td>3,000</td>
<td>60%</td>
</tr>
</tbody>
</table>

*True rental value even less after allowing for compound interest.*

**Table 4: Impact of errors**

<table>
<thead>
<tr>
<th>Effect of “error” of 1% in yield ($m)</th>
<th>Effect of error on rent ($m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>At 10% yield</td>
<td>9.1-11.1</td>
</tr>
<tr>
<td>At 5% yield</td>
<td>16.7-25.0</td>
</tr>
</tbody>
</table>

**Continued page 11**
recoverable-amount purposes, the “value” most relevant is the fair market value. Fair market value should be assessed on a present-value basis.

Passing the parcel

The impact of inflation and yield changes had different effects on different economic sectors. For example, real wealth was initially created for those investors who had significant debt and whose asset values rose. Investors who sold out realised their gains. However, by the end of the eighties, this realisation represented a wealth transfer from lenders (and their shareholders) to asset vendors. Once asset yields returned to their historic levels wealth had been redeployed but there had been relatively little change in real wealth.

During periods of rising asset values investors quite rightly concentrate on capital gains. Sadly, they tend to overlook the fact that they are really playing a sophisticated game of “pass the parcel”. The willingness of lenders to finance this game is hard to justify. Some investors clearly made gains while others lost. Substantial losses were also incurred by those who financed the purchasers.

The difficult issue is not whether the assets had the values ascribed to them at the time. In many cases they did, and transactions took place at those values (eg, the Fairfax privatisation). A value must take account of market transactions. The difficult issue for a financier, or an adviser to a purchaser, is determining:

- if, or when, the market might crash;
- if so, to what level?
- if so, for how long? and
- if it crashes, to what level will the market rise again and over what period?

The question is, then, how to set realistic levels of equity to be injected by borrowers a level sufficient to cover the lenders’ exposure in case of market downturns.

Financial institutions

The deregulation of the banking sector resulted in intense competition. Existing banks fought to maintain market share and new entrants fought to gain a foothold. The result was that too much money was chasing too few good investments or lending propositions, and prudential standards declined.

Further, with the apparent increase in values especially in property lending institutions, which were lured into a false sense of security by constantly rising security values, engaged in generous lending practices. Accordingly, when property values came tumbling down, so did a number of financial institutions. A few examples are Tricontinental, State Bank of South Australia, State Bank of Victoria, Rothwells, Pyramid/Farrow and Estate Mortgage.

Lending philosophy

The financing of the boom of the eighties and the impact of its dramatic collapse calls into question the lending and management philosophies of many Australian lending institutions.

Lending focused on asset values rather than real cashflows. It hardly seems prudent to lend 70 per cent of “value” when value is assessed on a 5 per cent yield that is, the underlying cashflow “securing” the loan is yielding just over 7 per cent (5 per cent yield on 100 per cent of property equals 7 per cent to fund interest payments, assuming a 70 per cent loan to security value) when interest rates (15 per cent plus margins) are more than double the rate of earnings of the underlying asset.

Lenders took what, in substance, were equity risks (ie, lent too high a percentage of valuation) at interest rates which were more appropriate for (relatively) secure debt funding. Capital market studies at the time indicate that equity risks commanded post-tax total returns in excess of 20 per cent (and sometimes 25 per cent in excess whereas lenders were lending at pre-tax rates of around 15 per cent to 18 per cent (ie, about half the rate applicable to an equity risk).

Lenders did not understand (did some even inquire?) or, if they understood, chose to ignore:

- valuation issues;
- the impact of the economic cycle and changes in equity and property yields;
- the fact that marginal lending practices which had their foundations before the boom, and the adverse impact of those practices, had (up to a point) been covered up by rising property and equity values;
- the importance of good information systems and the inadequacies in the lenders’ (and their clients’) systems; or
- that inflation partly hid investors and lenders’ early mistakes and the fall in the rate of inflation exacerbated their later ones.

Some lenders became too focused on growth for growth’s sake.

Two examples illustrate the point. “NAB’s solid result showed the bank is continuing to benefit from the unfashionably tight credit policies it enforced during the mid-1980s. During that time the bank’s credit bureau, then led by the present managing director, Mr Don Argus, isolated itself from the pack by refusing to lend to major commercial property developments and insisting on lending against cashflows or businesses” (The Australian Financial Review, 20 November 1992).

Continued page 40
NEW MEMBERS

Affiliates

Timothy Mervyn Ball SIA (Aff)
Gregory James Conway SIA (Aff)
Peter Colin Cuthbertson SIA (Aff)
Richard John Dall SIA (Aff)
Michael James Donovan SIA (Aff)
Jacinta Emmanuel SIA (Aff)
Alan David Fisher SIA (Aff)
William David Huysey SIA (Aff)
Ricky Neville Kennedy SIA (Aff)
John Peter Matthews SIA (Aff)
Martin Keith May SIA (Aff)
Chee Beng Ong SIA (Aff)
Bridget Garnet Smith SIA (Aff)
Michelle Smith SIA (Aff)

Self-employed
Australia & New Zealand Banking Group
FW Hector & Company Pty Limited
Mercer Campbell Cook & Knight
R M Fitzroy and Associates Pty Ltd
National Australia Bank Limited
Copers & Lyndsay
Self-employed
Kennedy Financial Services
Deutsche Bank Australia
Manxin Investments Pty Limited
Royal Enterprise
North Broken Hill Peko Limited
Towers Perrott (Tullagheen)

WESTERN AUSTRALIA

Associates

Michael John Saunders SIA

Affiliates

Timothy Edmund Jones SIA (Aff)
Gary Ray Slaidden SIA (Aff)

Cape Bordaed Investments Pty Limited
National Australia Bank Limited

SIA PRIZES

The Life Insurance Federation of Australia Prize
Applied Portfolio Management (53)
Carolyn Colley
Bankers Trust Australia Limited, Sydney

The Authorised Dealers Association Prize
Money Market and Fixed Interest Investment (59)
Geoffrey Cohen
Potter Warburg Limited, Melbourne

The Sydney Futures Exchange Prize
Australian Futures Trading (60)
Michael Tuch
Medical Practitioners, Brisbane

The Australian Forex Association Prize
Foreign Exchange (61)
Carrie Babbage
State Bank of South Australia, Adelaide

The Australian Finance Conference Prize
Options Markets and Trading (62)
Steve Anagnos
SBC Domingues Barry Limited, Sydney

The Building Owners and Managers Association of Australia Prize
Property Investment and Analysis (64)
Carolyn Abbey
Sydney

The Ian Roach Prize
(Made possible through funds donated by the Australian Stock Exchange Limited)
Melissa White
Peake Lanks Kirwan Pty Limited, Melbourne

SUBJECT PRIZES

The Investment Funds Association of Australia Prize
The Securities Industry (21C)
Carmel McDonough
Shell Australia Limited, Melbourne

The Commercial Law Association of Australia Prize
Securities Industry Law (22C)
Matthew Koder
Sydney

The Australian Stock Exchange Prize
The Australian Stock Market (25)
Mark Thring
M.R. Lodge & Hill Pty Limited, Adelaide

The Sydney Futures Exchange Prize
The Australian Futures Market (26)
Luis Perez
Westpac Banking Corporation, Sydney

The Australian Stock Exchange Prize
Stockbrokers’ Administration Procedures (27)
Fiona Cork
Merrill Lynch, Sydney

The Authorised Dealers Association Prize
Bond and Money Markets (28)
Luis Perez
Westpac Banking Corporation, Sydney

The Personal Investment Prize
Personal Investment: Planning and Management (31)
Jonathan Sandig
Country Link State Rail, Sydney

CERTIFICATE IN FINANCIAL MARKETS

Outstanding achievements

The President’s Prize: Certificate Course Dux
Carolyn Farrell
Proserpine

ASSET VALUE

FIASCO

From page 11

This may be contrasted with another (State-based) bank which increased total assets more than three-fold between 1984 and 1988 from $3.14 billion to $11 billion and then increased further to $22 billion by 1991.

Conclusion

To re-draw briefly the sorry cycle and its causes and effects:
- demand was artificially boosted while supply was reduced;
- the cycle was self-perpetuating (up to a point);
- when the bubble burst, the downturn was exacerbated by the return of yields to more normal levels and the unwinding of the artifices;
- lenders fought to obtain or retain market share with a consequent lowering of prudential standards;
- lenders focused excessively on their current asset values (without understanding the valuation issues);
- lenders disregarded the real cashflows of borrowers;
- a substantial proportion of increased equity values was represented by intangible assets;
- despite its self-evident commercial merit and other accounting standards requirements, most companies ignore NPV in their accounts (ie, asset value are often overstated);
- accounting standards on intangible assets are also inadequate;
- even lenders, the essence of whose business is borrowing and lending at interest, do not (in some cases) value their non-performing loan receivables at net present value;
- accordingly, information provided to equity markets is unreliable;
- in the next boom the massive proliferation of derivatives, and the lack of understanding of how to value them, represent a potentially highly unstable combination.

Unless these issues are addressed and corrected by regulators, a rerun of the worst features of the 1980s seems almost inevitable.