INTRODUCTION

"Look, people were setting up dotcoms not just for food, but dog food; and not just dog food but Scottish terrier dog food!"

Bruce Dunleavie
Benchmark Capital

It is now clear that the hype and nosebleed valuations accorded the New Era sectors of the economy caused vast amounts of capital to flow towards these sectors, leading in turn to dramatic falls in return on capital and severe disappointment to investors' preceding expectations. Given that both outcomes were, to a large extent, not just predictable but inevitable then the real scandal of the last few years is not that money has been lost, but precisely why investing institutions thought the New Economy was so bullish in the first place. For Marathon, which places supply side industry analysis at the heart of its investment philosophy, the 5 year period to June 30th 2002 has at least generated decent relative outperformance with annualised outperformance of 620 basis points and 600 basis points for global and non-US, so-called "EAFE", portfolios respectively. In a sense the boom of the last 5 years can be seen as a stress test of the Capital Cycle investment approach that Marathon has advocated since the founding of the firm. Whilst the supply side approach has been clearly successful in identifying real risk from excess capital and competition, lingering doubts remain as to the ability of this approach to identify potentially rewarding sectors. Marathon's own experience provides interesting insights in this regard.

On the face of it consolidation and capital withdrawal should lead to higher returns on capital (and higher shareholder values) as predictably as the New Economy boom achieved the reverse for those industries. And to extend the (inverse) analogy, just as industrial consolidation should improve return on capital, so should valuations of those returns as investors would have been psychologically depressed by years of poor profits into ascribing low valuations to the cash flows concerned. Just as New Economy investors suffered a "double whammy" of disappointment so investors in industrial consolidation could enjoy substantial returns. However, Marathon's experience of the last few years has been less successful in this regard than one might expect. In hindsight this can probably be most often ascribed to analysis based on what proved to be invalid assumptions. The pitfalls can generally be considered under 3 basic headings, namely political and legal issues, globalisation effects and new (often so-called disruptive) technologies.

Just as capital had to flow toward the New Era sectors unhindered so as to achieve the full magnitude of the bust we are now witnessing, so in low return industries capital (and participants) must be free to exit. Often both are prevented. This month U.S. Airways has filed a shareholder value destroying Chapter 11 filing, this the company that United Airlines (UAL) was prevented from buying only last year. Why regulators in Europe and America persist in disallowing mergers in low return industries (like airlines) whilst permitting them in industries like pharmaceuticals with egregious returns on capital (howsoever calculated) is a mystery that only politicians would be able to comprehend. And it can get worse; rarely in a bankruptcy filing are assets transferred to more efficient operators; rather in a bizarre reversal of survival of the fittest the "weakest link" is reborn in debt free mode, as creditors are bounced into a debt for equity swap which allows the stepchild company to emerge stronger than the competitors which originally outperformed it. It is a sobering thought that MCI WorldCom could yet be reborn in a format that puts it at a competitive advantage balance sheet-wise to AT&T (and other competitors) who have conducted their business affairs in a more responsible manner.

Globalisation is the second consideration. Industries where we have successfully implemented the capital cycle approach have been largely domestic by nature (e.g. banking, U.S. aerospace), which suggests the need to look at sectors in a global context. Many clients will be familiar with the long running Marathon overweighting to commodity cyclical companies, such as those in the paper industry. Indeed recently this is starting to pay off as these industries are characterised by greater capital discipline and consolidation world-wide, which is now being reflected in strong relative outperformance in the current economic downturn. The origins of this change is corporate behaviour can be traced to American forest product firms 15 years ago. However, while a company like Georgia Pacific appeared to appreciate that capex destroyed value, its European peers remained in aggressive expansion mode for a least a further five years. By the time sanity had dawned on these producers, the industry was perceived to have great growth potential in Asia and Latin America. Who can forget the US$10bn expansion plan of Asia Pulp and Paper, a firm with no visible means of support other than that provided by other people's money (OPM), gathered with the strong support of Morgan Stanley and various other investment banks? The analysis is rendered more complex by asset lives. That paper facilities have a longer life than, say, a semi conductor facility heavily influences the incubation time of a capital cycle idea. That eventual improvement in return on capital can be achieved is not in doubt, witness the more than satisfactory returns earned by the Swiss cement specialist, Holcim. For capital cycle investors global industry structures look less like a critical flaw in methodology than a factor which requires analysis and investor patience. It may therefore be an issue of duration rather than philosophy.

Finally there is the issue of new technology. We have often been asked (although not lately for some reason) whether we would have bought the last "buggy whip" company[*]. Emboldened by the suspicion that any company could be run in a mode which (subject to price) created value for shareholders, we have always maintained that we might have done so. Even when threatened with short term obsolescence a firm can/must be run to maximise distributable cash flows and the net present value of those payments could well exceed market capitalisation. Such a situation (involving competing technology) has arisen in the traditional steel industry where ongoing consolidation (and the exit of Government as a substantial shareholder) has attracted our interest. However, this industry has been undermined by the rapid growth of the mini mill industry whose products are of ever higher quality and are generated with a fraction of the capital employed by the large integrated producers. Partly as a result of this, LTV, a company in which Marathon clients had an investment, filed for Chapter 11 bankruptcy in a move that seems likely to wipe out shareholders' investment entirely. This would appear to contradict Marathon's bravado regarding the last "buggy whip" company. However, once again, all is not as it appears. Five years before its recent demise LTV had a market value of $1.7bn which together with virtually no debt and a pension liability of $1.2bn produced an enterprise value of $2.9bn. This appeared undemanding for a company generating $4.5bn of revenues and with balance sheet assets of $5bn.

[*] Such questions are less likely with the realisation that Hermes, the luxury goods company with a market capitalisation of $5.3bn, qualifies as the last "buggy whip" company. The firm was founded in Paris in 1837 as a harness maker and has evolved based on its core skills in exceptional craftsmanship and product quality.

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Table 1: LTV Corporation: The Last 4 Years (US$ millions)

	1997	1998	1999	2000
Depreciation & amortisation (d&a)	263	259	274	320 (est)
Capital Expenditures	326	362	290	220 (est)
Cash Acquisitions (inc. investment in affiliates)	514	80	650	0
Cash out (in) in excess of 75% d&a	643	442	735	(20)

Source: Company Statements & Marathon Asset Management

While recognition of the disruptive technology effect is important (both Marathon and LTV may have erred in this regard) appropriate business strategy is forever critical. In a mature business like steel production it should not have been beyond the wit of management to restrict capital spend to no more than 75% of depreciation, running down the equipment somewhat and shrinking capacity over the same timeframe. Yet this is not what happened; with LTV it was full steam ahead, Captain Edward J. Smith style, toward the icebergs that would eventually sink the company. Had the company run capex at 75% of depreciation (as consistently advocated by Marathon in company meetings) and refrained from cash acquisitions, cash flow would have been more than US$1,800 mill higher, and comfortably in excess of starting (1997) market capitalisation. None of this lessens the gravity of the investment error committed here, but suggests (at the least) that flawed corporate decision making is at least as guilty as any philosophical drawbacks of the capital cycle model.

Why the capital cycle is particularly germane to the investment process, as distinct from merely intellectually challenging, is that it lies at the heart of the mean reversion phenomenon. Traditionally investors have seen this in purely statistical terms but the real drivers of reversion are behavioural. Once one combines behaviour with the valuations that underpin it one has a truly remarkable investment tool. Not only does one have a device that is predictive and which explains mean reversion but, most importantly of all, one can comprehend why mean reverting return on capital is inevitable given patience and rational corporate decision making.
