

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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### Revisiting the land of the kiwi

New Zealand is the story of economic virtue, an even rarer commodity, if one might speculate, than moral virtue.

New Zealand's return from the brink has been profusely documented in these pages over the past seven or eight years, occasioning always-enthusiastic bursts and nearly always-profitable investment ideas. And so, in the mid to late '80s we advised taking advantage of 19% yields to be had in triple-A corporates, while enjoying the exciting secondary benefit of an appreciating currency.

Then, in April 1991, under the heading "New Zealand: once in a generation?", we suggested participating in forward purchases of the currency, the purchase of bonds, futures, and options on the Barclays share index, then trading just off six-year lows. By May 1992, we could not contain ourselves of excitement and wrote "New Zealand: an exciting investment story," providing specific recommendations to buy stocks and real estate. Clients of the firm were introduced to two investment vehicles specifically designed to participate in these markets.

And while the reward for moral virtue is virtue itself, the reward for economic virtue is prosperity. And that is exactly what is happening: GDP growth is forecast to be 5.6% in the year to March '95 on the back of a nearly 5% increase in 1993. The rate of unemployment has fallen to 7.5%, and annual employment growth has risen to 4.2%.

Fiscal *surpluses* are mounting, as spending is held below budgeted levels (see Chart 1), despite the sharp fall in revenues related to cyclical factors and also to substantial changes in the structure of incomes and employment associated with supply-side reforms. The June 1994 budget projected a *surplus* of NZ\$1.288 billion — roughly 3/4% of GDP for 1994-95 — and a NZ\$3 billion *surplus* for 1995-96. For 1996-97, a NZ\$5.02 billion *surplus* is projected, an amount equal to 4.5% of GDP.

But, as has been the case for the past two years, the surprises continue to come on the favorable side: In the upcoming December Economic and Fiscal Update, Finance Minister Bill Birch is likely to raise the government's expected operating surplus for 1994-95 to between NZ\$2.2 billion and NZ\$2.4 billion, while projecting small improvements in the outgoing years' projected surpluses.

The government will continue the 1994 budget goal of reducing net public debt. With a rapidly declining financial

deficit, asset sales, and the strength in the exchange rate, net public debt has begun falling from its peak of 51% of GDP recorded in 1992. It's now estimated at 42%, close to the projected OECD average.

The 1994 budget projections show New Zealand's net debt-to-GDP ratio declining to under 40% in 1995 and to 30% in 1997, well below the OECD average, which is expected to keep rising.

Keeping fiscal policy on track is the Fiscal Responsibility Act passed by parliament in June 1994. The Act calls for reducing public debt to prudent levels by achieving operating surpluses; maintaining debt at these levels by balancing the budget over an economic cycle; and achieving levels of public sector net worth that provide a buffer against untoward future events. This greater transparency in policy-making should improve accountability of policy by allowing the public to better assess the consistency of government action with stated objectives.

With the Reserve Bank Act and the Employment Contracts Act, which effectively deregulated and demonopolized

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Contributions by Albert D. Friedberg, Edison Lee, Sholom Sanik, Michael Hart and Andy Haibeck.

Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

the labor market, these Acts guarantee the continued economic virtuosity — and economic well being — of the people inhabiting the land of the kiwi.

The inflation projections contained in the Reserve Bank December Monetary Policy Statement see the underlying inflation peaking at 1.9% in December 1995/March 1996. With its 2% inflation target being in danger, the Reserve Bank has moved to tighten monetary policy: The yield curve has inverted, with 90-day bank bills at 9.5% *versus* the 8.9% yield on the February 2000, and 8.7% yield on the April 2004 issues.

This decisive preemptive move has caused the New Zealand dollar to rise significantly in recent weeks. Just over the last fortnight, the Trade-weighted Index has appreciated 1.9%. The Reserve Bank welcomes this currency appreciation as, with its help, New Zealand has managed to import significant *deflation*. In the year to September it has been

estimated that the non-oil import price deflator fell 4.5%.

The virtuous circles of fiscal rectitude — debt reduction, debt rating upgrades, capital inflows — and genuine commitment to price stability cum high interest rates cum capital inflows, leave little or no doubt that in real terms the New Zealand dollar will continue to appreciate for quite some time.

In the not-too-distant future, however, the Reserve Bank will need to allow for a gradual easing of interest rates lest the country move into outright deflation caused by a too rapidly rising currency.

The combination of a strong currency, above-average economic growth, and below-average inflation combined with gently falling long-term interest rates makes for a wonderful opportunity to accumulate financial and real (equities and real estate) assets. In the pages of this issue we describe some of these opportunities.

Chart 1

Budget projections and outcomes<sup>1</sup>  
Per cent of GDP

Fiscal years	1990/91		1991/92		1992/93		1993/94	
	Budget	Outcome	Budget	Outcome	Budget	Outcome	Budget	Estimated outcome
Budget balance <sup>2</sup>	-1.6	-3.5	-2.4	-3.3	-4.2	-2.3	-2.8	0.6
Revenue	40.7	37.7	38.2	36.5	35.1	35.3	35.2	35.5
<i>of which:</i>								
Tax revenue	36.7	35.0	35.8	33.9	33.2	33.7	33.1	33.3
Expenditure	42.3	41.2	40.6	39.8	39.2	37.6	38.0	34.8
<i>of which:</i>								
Debt servicing	5.9	6.3	6.1	5.7	5.6	5.1	4.9	4.3
<i>Memorandum item:</i>								
Primary balance <sup>3</sup>	4.3	2.0	3.7	1.6	1.3	2.1	1.5	4.3

1. Government budget excluding local authorities.
  2. Adjusted financial balance, excluding the proceeds from the sale of Crown Forestry assets and unrealised foreign exchange gains and losses.
  3. Excluding interest payments.
- Source: New Zealand Treasury, Budget documents.

## INTEREST RATE FUTURES

# Orange County cools the Fed — for now

The Orange County problems may have already exacted a price: a lessening in the Fed's determination to push for tighter monetary conditions. This is implied by the fact that at today's meeting the Fed decided to take no action despite the market's expectation, as recently as last week, of a 1/4 percentage point increase in Fed funds. The suspicion is now that the Fed will wait to see if more financial tremors come to light, before it tightens again.

We should remember that the Fed began to lower rates in 1989 more out of concern for the weakened conditions of the banking system than for the looming recession. In fact, the Fed continued to ease into late 1993, well past the trough of the 1990-91 recession. Clearly, the Fed demonstrated greater

sensitivity to the health of the financial system than to the real economy. (No judgment is implied in this observation.) One would have to surmise, however, that Orange county and many such similar punting operations weigh heavily on Fed governors.

We have repeated *ad nauseam* that the ultimate responsibility for the type of financial gambling that brought down Orange county lies squarely and directly with the Fed. By artificially lowering rates, it has fostered and even encouraged imprudent behavior. The carry trade, borrowing short and lending long, with spreads of up to 400 basis points and almost no money down, is too big a temptation for: a) young gunslingers under 30 years old; b) older but greedy investors;

c) anyone else playing with someone else's money. In short, nearly everyone. As we said in our September 26, 1993, comments, "The Fed has created a 'bubble,' and it does not know how to burst it gently. *There is no way to burst it gently.*"

Superficially, the Orange county problem resembles the numerous financial crisis of the past 25 years. Following each and every case (see Chart 2), long-term interest rates fell as the rise in rates appeared to have impacted the real economy. The facile comparison leads one to conclude that now, too, long-term interest rates are about to go lower.

In the short run, this may be true, as perceptions overtake reality. Reality, however, is that the Fed is still applying pressure on adjusted reserves: For the period Oct. 12 to Dec. 7,

they are down 16.8% on a compounded annualized basis. And again, reality is that the economy remains extremely robust and that the main commodity indexes hover near their recent highs. Inflationary pressures are gathering, and further tightening is inevitable.

In sum, Orange county has brought some respite to the debt markets. This breathing room may not last more than four to six weeks, after which time the Fed will be forced by rising commodity prices to tighten another notch.

**STRATEGY:** In our flash update of December 13 we advised covering the short March '95 T-bond position, then trading at around 99.09. Stand aside for now.

Chart 2



**CURRENCIES**

**Currency roundup**

In the above comments we anticipate a brief pause in the interest rate spiral owing to the discovery of strains in the financial system caused by flattening of the yield curve. The highly sensitive foreign exchange market has detected the quandary in which the vacillating Fed finds itself: the US dollar has stopped rising, opening the possibility of another dip.

The new governor of the Bank of Japan, Mr. Yasuo Matsushita, has in recent days expressed concern with the pace of economic recovery and the very poor state of the Japanese banking system. Bank loans in November were down 0.1% year-on-year, making it almost impossible for the banking system to regain sufficient profitability so as to eliminate its bad loans problems (estimated to exceed 7% of total loans).

The changing focus of the BOJ's concern may account

for the unusual rescue of two small banks with a combined deposit rate of a mere ¥243 billion. As they did not represent any kind of systemic risk for the banking system, it is clear that the patience of the Monetary Authorities, and probably MoF, is beginning to wear thin. One senses that reflation, with a capital R, is on the way. If so, our bearish stance on the yen will be amply vindicated.

The Swiss franc/deutschemark (SF/DM) cross rate has been extremely sensitive to interest rate differential between these two countries. Since early October, three-month LIBOR has moved in favor of German rates by over 50 points (see Chart 3), with a consequent 2.1% depreciation of the SF against the DM. We believe that the market has paid too much attention to the Swiss National Bank's tacit acceptance

of the widening in interest rates.

While in nominal terms the differential stands at 130 basis points in Germany's favor, in real terms the differential, based on prospective 1995 inflation rates, favors Switzerland by approximately 40 basis points. Moreover, the Swiss National Bank enjoys a highly credible monetary policy, almost exclusively based on targeting the money base. Their adherence to monetarism is a great deal stronger than the Bundesbank's. And this is reflected in the much smaller degree of overshooting in the adjusted money base for Switzerland than in the M3 for Germany.

With only a little bit of hesitation, we continue to favor the SF over the DM.

We are beginning to take a favorable view on Sterling. Attesting to the UK's new competitiveness, its trade deficit in the third quarter this year fell to the lowest level for almost 10 years. Official figures suggested last week that the UK may have recorded a quarterly current account surplus for the third quarter this year, the first such surplus in any quarter for almost eight years. This runs counter to the widespread belief that the British recovery would suck in imports and

lead to a deterioration in the current account.

Also favorable is the impression gaining ground that the UK authorities are regaining control of the country's finances. With a government deficit set to fall below 2% of GDP by fiscal 1996-97, Chancellor Clarke may have stabilized the net government debt to GDP ratio at below 50%, an unequalled feat among the G-7.

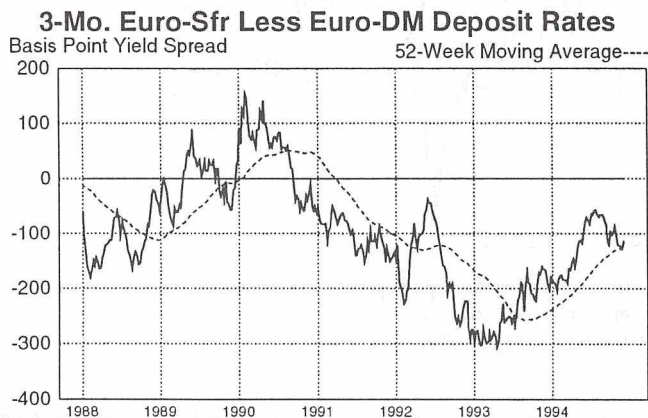
Finally, interest rate differentials have continued to widen in favor of the UK (see Chart 4) and now stand almost 100 basis points higher than three-month DM rates.

**STRATEGY:** 1. We are close to recommending a short position in the US dollar.

2. We recommend retaining the short yen/long SF cross trade; its two basic components the yen/DM and SF/DM are looking more stable, with the latter still to be monitored for breakouts above 0.85.

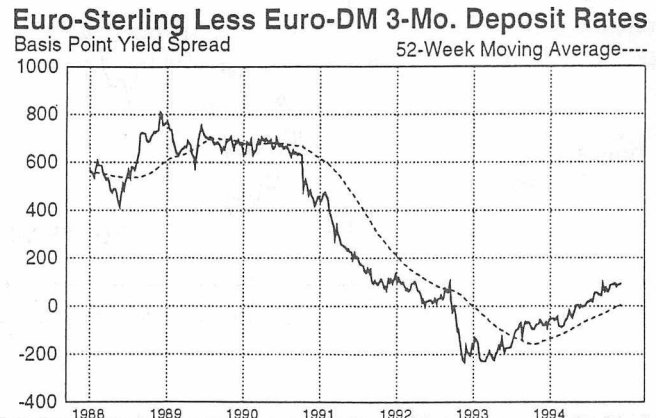
3. We recommend a long Sterling/short DM cross, currently trading around 2.45, basis spot. Our initial objective is 2.52; risk is at 2.43.50, basis New York close.

Chart 3



Currency & Bond Market Trends — December 8, 1994

Chart 4



Currency & Bond Market Trends

## CANADIAN DOLLAR

# Belt-tightening is funding the great escape

The income-shrinking effects of the 3-year long depreciation of the Canadian dollar is beginning to affect the external sector. Canada's merchandise trade surplus almost doubled in the third quarter, increasing to \$5.1 billion from \$2.7 billion, its highest quarterly level in almost a decade (see Chart 5), and reducing the current account deficit to its lowest quarterly level in more than four years. As a result, the deficit fell to 2.75% of gross domestic product on an annual basis — its lowest share in seven years.

But let there be no joy. This so-called improvement is the result of the real shrinkage of incomes that comes from

devaluation, as we said earlier, and from increased taxation, actual and expected. In fact, the mercantile improvement is a sign that the nation is becoming impoverished.

With it all, the growing trade surplus, bought at the expense of consumer belt-tightening, is not nearly high enough to offset the leakage in the capital account. Temporarily plugged by the post-Quebec election euphoria, capital outflows have resumed. A falling dollar and the almost daily currency interventions by the Bank of Canada are absorbing this accelerating leakage, sometimes terrified by developments in Quebec and sometimes terrified by the prospects of

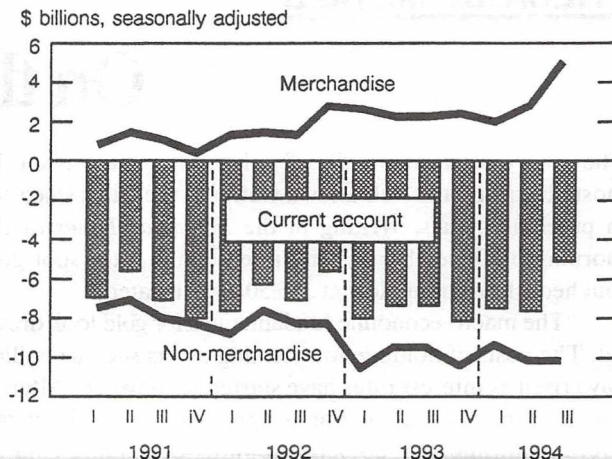
government deficits at all levels reaching a new record level of (7% of GDP).

It is noteworthy that in Canada, public spending has accounted for rising share of national income in each cycle over the past couple of decades, thanks to increasing structural unemployment, more generous welfare payments, rising evasion, and wasteful subsidies. This inability to control spending implies rising levels of taxation well into the future. Little wonder that capital wants out.

More poverty and bigger trade surpluses are ahead to fund the great escape of capital.

**STRATEGY:** Remain short; lower stops to 72.50, basis nearby.

Chart 5



**STOCK INDEX FUTURES**

**Bearish but not ready to commit**

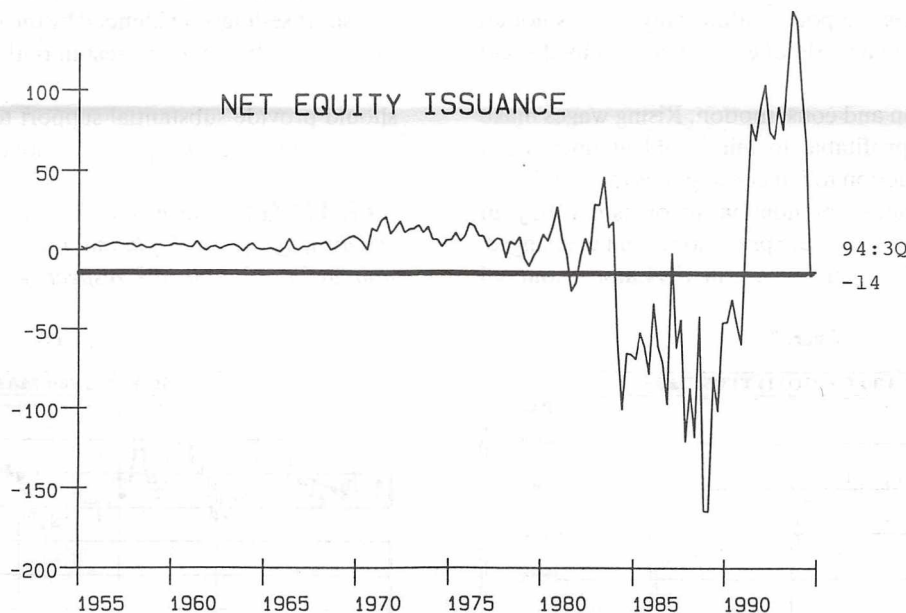
The stock market's extraordinary resilience to rising interest rates is a result as much of strong earnings as favorable technical factors. In the first place, with only 20% to 25% of stocks above their 200-day moving averages, the market appears sufficiently oversold to justify the ongoing rally. Secondly, for the first time since 1990, there was a decline in net equity issuance (see Chart 6). Finally, sentiment has been much too negative.

Interestingly, insider confidence remains high: Sell/buy

ratios are indicating historically high levels of purchases among corporate executives and directors for the shares of their own companies, supporting the view that corporate earnings have not peaked as yet.

**STRATEGY:** Although we remain generally bearish, we are not willing to commit to the short side until the nearest S&P 500 contract (now March 1995) breaks 444.00 on an intra-day basis.

Chart 6



INTERNATIONAL STRATEGY & INVESTMENT GROUP INC.

**PRECIOUS METALS**

# On the way up

The otherwise sagacious "Lex" column may have been the most illustrious and well-known victim of the latest shakeout in precious metals. Writing in the *Financial Times* of the morning of December 6, only a few hours after spot gold touched a four-month low at 375.50/oz., it stated:

"The macro-economic fundamentals for gold look dreadful. The costs of holding non-yielding assets such as bullion have risen as interest rates have started to move up. Alternative investments such as bonds appear increasingly attractive. Meanwhile, the potential rewards of holding gold remain few and far between. Precious metals have traditionally been viewed as a hedge against inflation. That rationale may no longer be valid: The general breakdown of international exchange controls allows investors to switch out of depreciating currencies; and the developments of sophisticated derivative instruments means there are more effective ways of offsetting inflationary dangers.

"Fundamentals apart, the current absence of any significant inflation in Europe, Japan, or the US provides little incentive to hold the precious metal. Nor does the supply-demand balance give cause for comfort. With the gold price falling to a 16-week low yesterday, Asian and Middle Eastern investors — who generate 55% of demand — have few reasons to buy bullion. Many have already been burned by the depreciation of their dollar-backed assets against their local currencies.

"On the supply side, any decent price increase tempts mine owners to raise production or central banks to release gold reserves. For the gold price, the worst of all possible worlds seems to have materialised."

The writer misses the point. Admittedly, gold is not an ideal inflation hedge in a world of earnest central banks and positive interest rates. Nevertheless, inflation does affect the balance of production and consumption. Rising wages make it increasingly less profitable to mine gold at unchanged prices, causing production to fall and supplies to diminish.

At the same time, rising nominal incomes can buy an increasing amount of bullion were prices to remain unchanged. One need only look at China where in 1994 alone nominal

incomes grew better than 35% *in dollar terms*, or India where they grew better than 20%. It is these consumers who absorb the entire (and more than the entire) supply of newly mined gold.

Consumers, then, are likely to buy more — not less — gold after the price falls to a 16-week low. (There is little or no evidence that Asian and Middle Eastern investors generate 55% of demand as the "Lex" column states; however many they are, they are consumers, not investors).

Nor is the "Lex" column correct in stating that "any decent price increases tempt mine owners to raise production or central banks to release gold reserves." There is a long lead between rising prices and rising production, as we saw in the '70s and '80s. As to his second argument, central bankers, like any other bureaucrats, are not rewarded for being heroes and selling into a rising market.

Finally, the "Lex" column forgets that gold is as significantly underowned in private portfolios — if Swiss banks are any guide — as it has been in the past 60 years. Rising prices, brought about by increases in consumption and a tapering off of production, will trigger a revival in investors' appetite that has the potential of raising prices high enough to ration consumption in the short run and increase production in the long run. The magic number, given the elasticity in demand for jewelry, is somewhere in the area of \$700 to \$800/oz.

The violent October-through-early December shakeout was particularly severe on silver, which retraced as much as two thirds of its previous advance, and less so on gold and platinum, which saw corrections of a mere 6% and 7% respectively from their highs. The decline attracted heavy speculative short selling as evidenced by the unusual 30,000-contract increase in the open interest in both silver and gold and the record open interest level achieved by platinum. These "shorts" should provide substantial support to prices, enabling them to move past recent highs in the not too distant future.

**STRATEGY:** You are long once again April '95 gold, March '95 silver, and April '95 platinum, at 383.50, 4.85, and 415, with stops at 381.50, 4.60, 399, respectively, close only.

Chart 7

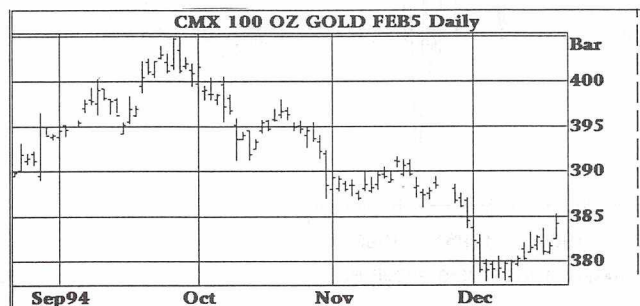
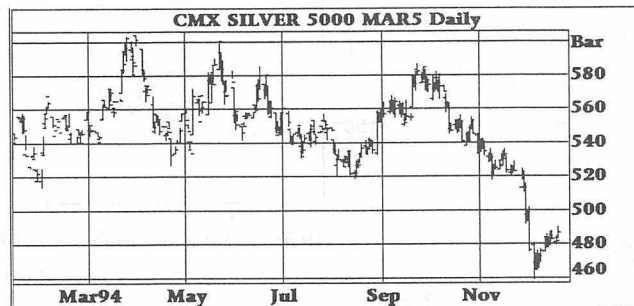


Chart 8



**COMMODITIES**

# Sugar still playing an old, sweet song

Can sugar prices hold? After all, cocoa and coffee prices have plunged in the wake of possible consumer mutiny against high prices. We think they can. Here's why.

Cuba, once the world's largest exporter of sugar has fallen on hard times. It can't be counted on as a bullish factor. But the market is assuming that other producers will pick up the slack. Will they?

India and Brazil, both major producers, had poor crops in 1993-94 owing to poor weather. But they're expected to bounce back in 1994-95 with big crops.

Although India imported 1 million tons in 1993-94, it still needs a further 500,000 tons to meet growing domestic demand. Since 1989, sugar consumption in India has grown a staggering 25%, the highest rate among the big users. Yet factoring in this year's expected production, sugar production in India since 1989 will show a growth rate of only 15%.

Brazil is expected to produce 1 million tons more than last year. But just about all the excess will be eaten up by a growing domestic sweet tooth. Sugar broker C. Czarnikow reports that Brazilian sugar consumption is running 12.6% above the same period last year. In addition, the Brazilian government slapped a 10% export tax on sugar that could well keep additional sugar from the export market.

Chinese demand is the biggest factor of all. Chinese production has been slipping, and they've shown a propensity for buying at rich prices. Domestic production has been in

decline since the 1991-92 crop year. Because of creeping capitalism, farmers have been shifting their land to more profitable crops.

But consumption has held steady. And in fact it's expected to rise 10% over last year. There's money for imports, because of China's falling current account deficit. And hundreds of millions of people will soon be trying their first Coke, Mars Bar, or Twinkie, all with high sugar content. All of this should keep Chinese demand strong for some time to come.

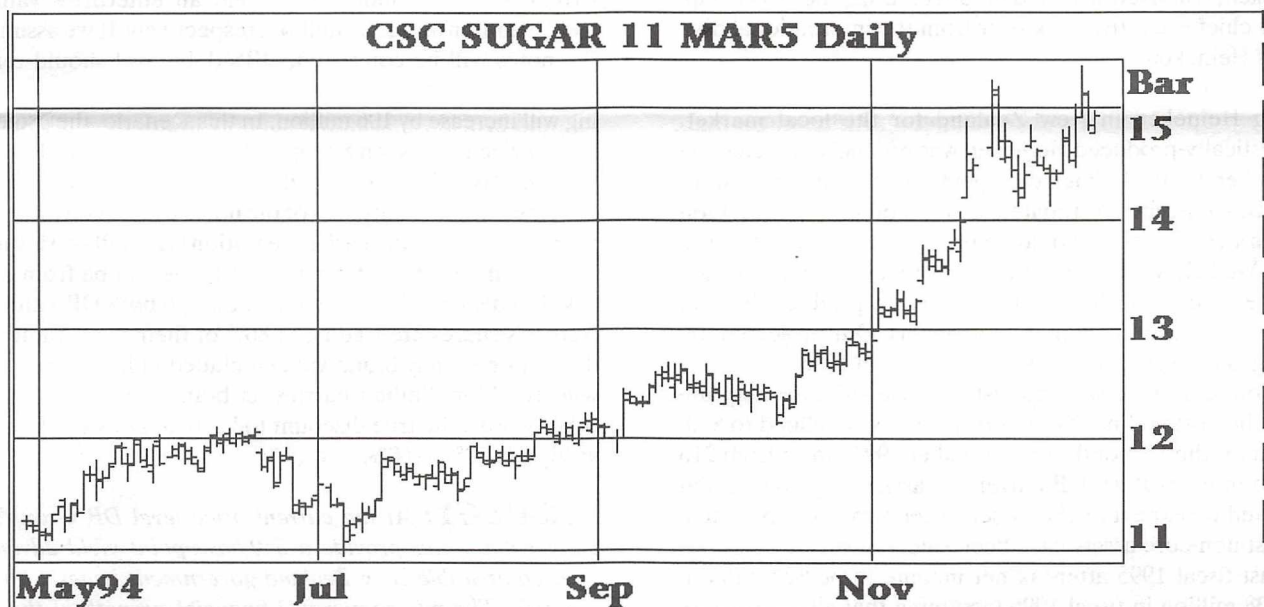
Although sugar substitutes have made inroads in the Western world, they're just not a major factor in the less-developed countries. And it's those countries that will lead the bull market in sugar.

Now, assume that booming Brazilian demand shaves, say, 500,000 tons off their expected exports. And suppose Indian production were to reach the average crop size of the last five years, increasing only 1.3 million tons rather than the anticipated 2.6 million tons. The result: A 1994-95 deficit of 3.7 million tons, bringing the carryover as a percentage of consumption down to an extremely bullish 27.5% (on an ISO basis).

**STRATEGY:** Remain long with new stops at 14.10, basis March '95, close only.

— Sholom Sanik

Chart 8



**FRIEDBERG CAPITAL MARKETS****Update on DB Group Ltd.**

(All dollar and cent figures below are in NZ currency)

**Security:** 7% non-callable subordinated convertible notes

**Maturity:** June 30, 1996

**Conversion:** 85¢ cash or one common share of DB Group

**Recent price:** 79¢ per dollar

**Yield to maturity:** 15%

DB Group recently announced its 15-month results ended September 30, 1994, since it has moved its fiscal year-end from June to September. It suffered a net loss of \$93.2 million, which included one-time asset writeoffs of \$113.8 million. The after-tax income excluding the writeoffs was approximately \$21 million. The majority of the writeoffs was related to disposing of its 50% interest in Austotel.

The results showed a strong improvement in operating profits (earnings before interest and tax) in the six months to September 1994 over the same period a year ago. However, since the company experienced a margin decline in the first half of fiscal 1994, the full-period operating margin of 4.9% was still lower than the 5.3% last year.

Our estimate shows that all divisions' operating margin, except DB Breweries, improved during the 15-month period. Even for DB Breweries, we saw a strong operating margin rebound in the last six months of the 15-month period. The recovery was mainly due to successful cost cutting efforts, more focused and effective marketing, and less price discounting in the beer market.

Although DB Breweries has lost approximately 1.5% of market share to Lion Nathan during the period, it plans to more than make up for it by improving productivity. The majority owner Asia Pacific Breweries, 80% owned by Heineken, is actively involved in restructuring the DB Group. A new chief executive took over from the international division of Heineken.

Recently Heineken has given permission to DB for producing Heineken in New Zealand for the local market. Domestically-produced Heineken was officially launched on November 29, 1994. Since the operating margin of DB Breweries was currently estimated at 6% compared with Lion Nathan's 18.2%, there should be plenty of room for improvement. We believe that with the help of Heineken, DB would be able to narrow the gap by improving productivity and increasing sales of high-margin products. Our projected operating margin is 7% in fiscal 1995 and 9% in 1996.

Considerably lower interest expense will also help improve the bottom line. Net interest expense declined to \$5.8 million for the 15 months to September 1994, down from \$16 million in fiscal 1993. DB currently carries only \$60 million debt, and we expect further asset writedowns to be minimal, as most non-core assets have been sold. On such a basis, we forecast fiscal 1995 after-tax net income to be \$27 million, and \$38 million in fiscal 1996 (assuming that all convertible notes are exchanged for shares).

DB's financial position is currently very strong. It had sold non-core assets for \$197 million in the 15-month reporting

period and used the proceeds to pay down debt. Its long-term debt declined to \$60 million from \$247 million at the end of June 1993. With \$70 million cash, it is in fact in a net cash position of \$10 million. Chart 9 shows that its financial strength is much better than that of its largest competitor, Lion Nathan. Consequently, DB has more than adequate debt capacity to refinance the convertible notes (\$106 million) if all holders decide to redeem them in cash.

The 7% convertible notes are currently trading at 79¢ per dollar. At this price the yield to maturity is over 15%, based on the assumption that the principal redeemed is 85¢, which is the downside in this case. As pointed out above, we see very little risk in recovering less than 85¢ because DB's strong financial position can easily support a 100% cash redemption. Therefore, we would view the 15% yield at the current price the floor return with minimal downside risk.

To assess the upside potential on the notes requires projection of DB's stock price in the next 18 months. The return can exceed the floor level if the stock trades above 85¢ at the time of conversion.

Chart 10 shows valuation statistics of both DB and Lion Nathan. DB's stock is currently trading at a very similar total enterprise value to EBITDA multiple to Lion Nathan's. We believe Lion Nathan should have a higher multiple because of its higher profit margin and faster growth potential (project in China and joint venture with Pepsi). Therefore, the comparison suggests that DB's stock is overvalued based on its current profitability.

We expect a multiple gap to emerge with DB's multiple contracting and Lion Nathan's expanding. However, DB's multiple should not go down substantially owing to its continued profitability improvements. A range of 6.5X to 7X is very likely in 1996. Applying 6.5X and 7X to our 1996 forecast EBITDA of \$75 million will yield an enterprise value of \$487.5 million and \$525 million, respectively. If we assume all the notes will be converted, DB's debt level should remain approximately the same, but the number of shares outstanding will increase by 106 million. In this scenario, the projected stock price is between 82¢ and 91¢ (Chart 11). A redemption value of 91¢ will push the yield on the notes up to 20.7%.

If we assume only 50% of the notes will be converted into shares and half of the cash redemption (\$27 million) is funded by debt, the projected stock price range will be from 86¢ to 97¢. It is also worth noting that, although both DB's and Lion Nathan's shares are trading at 80% of their book values, DB does not have any brand value included in its balance sheet, whereas Lion Nathan carries its brands at \$2.1 billion. In other words, the true discount to book of DB's stock may be as high as 50% to 60%.

**STRATEGY:** *At the current price level DB Group's 7% convertible notes provide a 550-basis-point yield advantage over comparable New Zealand government issues with very low risk. The much-improved financial strength of the company has almost made a 15% yield on the notes the floor return. Upside on the notes is substantial, as DB's shares may trade above 85¢ in 1996. We strongly recommend a buy.*

**Chart 9 – Comparative Financial Position**

	DB Group	Lion Nathan
Current ratio	3.14	0.75
Debt to equity	0.81	0.92
Debt to market cap	1.09	1.16
Pretax interest coverage	6.05X	2.25X

**Chart 10 – Comparative Valuation Statistics**

	DB Group	Lion Nathan
Market cap (\$ million)	234	1,643
Total debt (\$ million)	254	1,909
Total enterprise value (TEV)	488	3,552
EBITDA*	65	480
TEV to EBITDA	7.45X	7.40X
Price to book	0.8X	0.8X

\* EBITDA = Earnings before interest, tax, depreciation and amortization

**Chart 11 – Equity Valuation of DB Group**

TEV to EBITDA	6.5X	7X
Forecast 96 EBITDA (\$ million)	75	75
Projected TEV (\$ million)	487.5	525
Less: total debt (\$ million)*	148	148
Equity value (\$ million)	339.5	377
Shares outstanding (million)*	414.3	414.3
Projected share price (cents)	82	91

\* Assume the entire \$106 million issue of convertible notes are converted into shares.

## Update on Tranz Rail Ltd.

(All dollar and cent figures below are in NZ currency)

**Security:** 10% non-callable subordinated debentures

**Maturity:** October 15, 1999

**Recent price:** \$98.05

**Yield to maturity:** 10.52%

Since our first recommendation on the above debentures in February this year, they have returned investors 7.87% in US dollar terms. The return is impressive, considering the significant rise in interest rate of over 300 basis points during the period in New Zealand. The return comes mainly from a substantial appreciation of the New Zealand dollar and spread tightening of the debentures themselves. The debentures remain very attractive, since we expect more appreciation of the New Zealand dollar, further credit quality improvement of Tranz Rail, and potential interest rate decline for instru-

ments maturing three years and out.

Tranz Rail recently announced its fiscal 1994 results, with a 5.6% increase in revenue and 78% surge in operating profits. Net profits rose by 130%. Fiscal 1994 was the first year in which New Zealand Rail, the wholly-owned subsidiary of Tranz Rail, had been operated by profit-oriented private entities. The new management has dramatically improved the rail company's operating efficiency and, with the help of a strong economic recovery in New Zealand, achieved a turnaround in the financial results.

The new management has restructured Tranz Rail's operations. Now it can provide multi-mode transportation services that move customers' freight from its point of origin to its final destination instead of only railhead-to-railhead. In addition, it also has negotiated new agreements with its unions in order to introduce 24-hour services for its Interisland operations. This will make it possible to move cargos from Auckland (the north) to Christchurch (the south) within 24 hours. On the passenger services front, Tranz Rail renewed its agreement with the Auckland Regional Authority for 10 years for its Cityrail Auckland operations.

We are very optimistic about Tranz Rail's prospects. The new management has demonstrated its ability to run the business much more profitably than the government did and there should be more room for improvement. Chart 12 shows that Tranz Rail's operating margin is still below the average of its US counterparts, even though it is already five times better than last year. The global boom in various primary commodities should provide Tranz Rail with an even better business environment in the next two years.

The 10% subordinated debentures are currently trading at approximately 170 basis points above comparable New Zealand government issues, down from 220 basis points when we first recommended them. We believe the debentures are still undervalued. Chart 13 compares the financial strength and cost of debt of public rail companies. It shows that Tranz Rail's yield spread is significantly higher, while its financial position is comparable to that of the other three rail companies. Therefore, we expect further spread tightening in the next six to 12 months. Our initial target of yield spread is 100 basis points.

Chart 14 indicates the valuation levels of various North American rail companies using enterprise value to sales and enterprise value to earnings before interest and tax (EBIT). Applying the lowest multiples in the sample to Tranz Rail will give us an asset coverage of between 8.3X and 11X for the subordinated debentures (Chart 15). As a result, we believe the downside risk of Tranz Rail's debentures is quite small and its credit quality is at least equivalent to triple-B under the Standard & Poor's scale.

**STRATEGY:** *Tranz Rail's 10% subordinated debenture is a strong buy, as we expect further spread tightening, owing to steadily improving credit quality. The continued strength in the New Zealand dollar and a potential fall in interest rates should provide additional capital gain opportunities.*

Chart 12 – Comparative Operating Performance

Company	Sales (US\$ million)	Operating Margin (%)	ROA* (%)	ROE** (%)	Debt/Equity Ratio
TRL	327	15.3	6.5	26.6	2.7
Burlington Northern	4,897	16.6	5.2	18.6	2.6
Chicago & Northwest	1,116	20.3	4.0	30.1	6.4
Conrail	3,657	14.8	3.4	9.9	1.9
Norfolk Southern	4,495	22.9	6.1	13.6	1.2
Santa Fe Pacific	2,778	15.3	3.3	16.4	4.0
Illinois Central	582	32.4	8.2	24.4	2.0
Average w/o TRL		20.4	5.1	18.8	3.0

\* ROA = Return on assets \*\* ROE = Return on equity

Chart 13 – Comparative Valuation of Rail Bonds

Issuer	Coupon	Maturity	Yield	Spread over gov't	Debt/Equity Ratio	Pretax Interest Coverage
TRL (NZ)	10%	10/15/99	10.52%	170 bps	2.74	2.94
Canadian Nat'l (CN)	9.625%	5/14/99	9.58%	62 bps	1.90	0.70
CSX (US)	4.5%	7/1/99	8.28%	54 bps	2.98	3.78
Burlington Northern (US)	3.125%	1/1/00	8.50%	74 bps	2.64	5.21

Chart 14 – Comparative Valuation of Rail Companies

Company	Sales (US\$ million)	EBIT (US\$ million)	TEV* (US\$ m)	TEV to sales	TEV to EBIT
Burlington Northern	4,897	811	10,015	2.05	12.35
Chicago & Northwest	1,116	240	2,764	2.48	11.52
Conrail	3,657	649	9,397	2.57	14.48
Norfolk Southern	4,495	1,115	14,182	3.16	12.72
Santa Fe Pacific	2,778	488	7,709	2.77	15.78
Illinois Central	582	194	2,170	3.73	11.18
Average				3.04	13.35

TEV = Total enterprise value

Chart 15 – Asset Coverage Estimate

	TEV to sales at 2.05*	TEV to EBIT at 11.18*
Enterprise value (\$m)	1,054.4	878.3
Less: current liab. & senior debt	337.6	337.6
Balance	716.8	540.7
Coverage for the debentures' face value	11X	8.3X

\* The lowest multiples in our sample - see Chart 14

## Correction re TWA

Security: 10% senior secured notes

Recent price: \$53.50

In our last discussion on TWA, we mentioned by mistake that they missed the November 3 coupon payment. The fact is that the next interest payment will be on February 1, 1995. Whether it will be delayed or in what form it will be paid is part of the negotiations. Stay tuned.

– Edison Lee, CFA

## KIPT: A NZ REIT

Here's another way to take advantage of the opportunity to acquire real assets in New Zealand: the Kiwi Income Property Trust. This is a NZ\$260 million closed-end real estate fund that trades at a significant discount to net asset value (about \$1.15 per share).

Kiwi is managed by a Friedberg Mercantile affiliate in partnership with a successful team of New Zealand real estate managers.

Its portfolio of commercial and industrial properties earns a real economic return of about 10% just from lease payments received from prime properties with AAA-quality tenants.

The fund's gross dividend yield is 9% at current prices. When the dividend is added to market value increases, the shares have shown an average annual rate of return of better than 20% since Friedberg's initial involvement.

KIPT has a lot going for it: It earns the kind of income you get from a quality long-term bond, yet unlike a bond, it's not a "loan" – it's stock market equity ownership; it's an investment in hard assets, like gold or silver; and it's an investment in a currency that we favor.

**STRATEGY:** We recommend the purchase of Kiwi Income Property Trust for safety-conscious investors who want secure income and growth potential. Please call our New Zealand investment hotline for more information. In Toronto, call (416) 777-0444. Throughout Canada and the US, call 1-800-661-6684.

– Andy Haibeck

Chart 16 – Breakeven exchange rates for US\$-based investor

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ\$, A\$, DM, DKr, BP, CD, SAR, ECU, ITL, and ARG) or revalue for FFr, FIM, SF, JY, before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. Rates as of December 19, 1994.

	U.S. \$	NEW ZEALAND	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND	FRENCH FRANC	EUROPEAN CURRENCY UNIT	CANADIAN DOLLAR	SOUTH AFRICAN RAND**	ITALIAN LIRA	ARGENTINEAN PESO	FINNISH MARKKA
1 year	7.12%													Finland '95 yields 6.43% (FIM/US 4.8426)
2 year	7.57%		VEB 7% '96 yields 15.73% (DM/US 1.8213)		World Bk. '96 yields 2.84% (JY/US 91.5179)	Denmark '96 yields 7.69% (DKr/US 6.1893)	Sweden '96 yields 7.88% (US/BP 1.5520)	Cr. Lyon '96 yields 7.51% (FFr/US 5.4130)			ESCOM '96 yields 14.68% (SAR/US 0.2194)	NIB '96 yields 10.76% (ITL/US 1.7445)		
3 year	7.71%									R.B.C. '97 yields 8.78% (CDN/US 1.4366)				
4 year	7.74%		Argentina '98 yields 7.72% (DM/US 1.5723)											
5 year	7.76%	Tranz Rail '99 yields 10.49% (US/NZ 0.5647)		G.E. '98 yields 5.19% (SF/US 1.1810)										
6 year	7.77%								UK '01 yields 8.42% (US/ECU 1.1684)					
8 year	7.82%												BIC V '01 yields 18.46% (ARG/US 2.1187)	
Spot Exchange Rate	—	0.6399	1.5735	1.3325	100.13	6.1755	1.561	5.419	1.2113	1.3946	0.2494	1.6455	0.9979	4.874

\*For example, since a US\$-based investor would receive 273 basis points (1049-776) by holding the Tranz Rail NZ\$ bond, the NZ/US can depreciate to .5647 from the present spot exchange rate of .6399 over

the next 5 years for the NZ investment to break even with current US\$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

\*\*NOTE: These bonds pay interest in commercial rand, which presently trades at a premium to the financial rand used for this table.

## HOTLINE UPDATE

**Tuesday, November 29:** No changes or recommendations.

**Flash Update, Thursday, December 10:50 am:**

Sell Japanese yen at the market, presently trading at 10173.

**Friday, December 2:**

There are no changes or recommendations. The following is a recap of this week's recommendations: On Thursday, December 1, via flash update at 10:50 am, we advised you to sell Japanese yen at the market, then trading at 10173.

**Tuesday, December 6:** Four new recommendations.

Buy February crude oil at the market; place initial stops at 16.55, close only.

Sell March copper at the market; place initial stops at 135.00, good anytime.

Buy March cocoa at the market; place initial stops at 11.95, good anytime.

Buy March coffee at the market; place initial stops at 150.00, good anytime.

**Friday, December 9:** There are no changes or recommendations.

The following is a recap of this week's recommendations:

On Tuesday, December 6, we had four new recommendations: Buy February crude oil at the market; initial stops were placed at 16.55, close only. Sell March copper at the market; initial stops were placed at 135.00, good anytime. Buy March cocoa at the market; initial stops were placed at 11.95. Buy March coffee at the market; initial stops were placed at 150.00.

On Wednesday, December 7, the above-mentioned opened as follows: February crude oil 16.55; March copper 129.70; March cocoa 12.65; and March coffee 166.70.

**Flash Update, Monday, December 12, 8:22 am:**

We have two new recommendations: Buy April gold at the market, presently trading at 383.50; place stops at 381.50, close only. Initiate a long position in March silver by buying March silver at 485 stop.

**Flash Update, Tuesday, December 13, 10:00 am:**

We are making a clarification regarding the S&P.

Based on the market letter of November 27, you would be short S&P on any move below 444. We failed to add that this was based on the most active contract, i.e., March 95. Therefore, you should not be short, even though the December traded below 444 this past Friday. If you misunderstood the message, cover immediately, and set your sights on 444, basis March.

We also have two new recommendations. Buy April platinum at the market, presently trading at 415.00. Close out, outright, short March yen positions at the market, presently trading at 10077.

**Tuesday, December 13:**

We have one new recommendation. Cover short T-bond positions at the market cancelling the stop at 103.01.

The following is a recap of this week's recommendations.

On Monday, December 12, at 8:22 am we flashed two recommendations: Buy April gold at the market, then trading at 383.50; stops were placed at 381.50, close only.

Initiate a long position in March silver by placing a stop at 485.00. Please note this stop was executed today (being Tuesday), and you are therefore, long silver.

This morning, via flash update at 10:00 am, we made a clarification regarding the S&P. Based on the market letter of November 27 you would be short S&P on any move below 444. We failed to add that this was based on the most active contract, i.e., the March 95. Therefore, you should not be short, even though the December traded below 444 this past Friday. If you misunderstood the message, cover immediately and set your sights on 444 basis March.

We also made two new recommendations: Buy April platinum at the market. April platinum was trading at 415.00. Close out, outright, short March yen positions at the market, then trading at 10077.

**Friday, December 16:** We have three new recommendations:

Place stops on long March silver positions at 460.00, good anytime.

Raise stops on long March sugar positions to 14.10, good anytime.

Buy March coffee at the market, risking 140.00, good anytime.

The following is a recap of this week's recommendations:

On Monday, December 12, we made the following recommendation: We advised you to buy April gold at the market, then trading at 383.50; stops were placed at 381.50, close only. We advised to initiate long positions in March silver by placing stops at 485. Please note: This order was executed, and you are long silver. We also advised you to cover short T-bond positions at the market, cancelling the 103.01 stop.

On Tuesday, December 13, we made the following three recommendations: We are making a clarification regarding the S&P: Based upon the market letter of November 27, you would be short S&P on any move below 444. This should have been based on the active March contract; therefore, you should not be short, even though December traded below 444 on Friday, December 9. If you were short, we advise that you cover immediately and set your sights on 444 basis March.

We advise you to buy April platinum at the market, then trading at 415.00 and to close out, outright, short March yen positions at the market, then trading at 10077.

**Tuesday, December 20, 1994:**

This is a complete summary since our last market letter dated November 27, of all liquidations of open positions and new recommendations that remain outstanding:

Via Flash Update on Tuesday, December 6, we advised you to buy February crude oil at the market, then trading at 16.55, risking 16.55 stop, close only. We advised you to buy March cocoa at the market, then trading at 12.65, risking 11.95, good anytime.

On Monday, December 12, we advised you to buy April gold at the market, then trading at 383.50, risking 381.50, close only. We advised you to purchase March silver at 485 stop, which was executed on December 13; stops were placed at 460.00 good anytime.

On Tuesday, December 13, we advised you to cover short T-bond positions at the market, then trading at 99.09; and, to purchase April platinum at the market, then trading at 415.00.

On Friday, December 16 we advised you to raise stops on March sugar to 14.10, good anytime and to purchase March coffee at the market, then trading at 158.30, risking 140.00, good anytime.

# FRIEDBERG'S

## Chart 17 – FOREIGN CURRENCY BONDS

DATE: December 20, 1994

We offer the following Bonds subject to change without prior notice: Minimum US \$4000 (CDN \$6000)

ISSUER / COUPON / MATURITY DATE	BID	OFFER	YTM	CURR. COUPON	NEXT INTEREST PAYMENT DATE
<b>DEUTSCHE MARK DENOMINATED BONDS</b>					
Bank of Nova Scotia 5 5/8% 7/5/96 RRSP	97.85	98.7	6.62		May-07
World Bank 5 7/8% 4/02/97 RRSP	99.9	100.75	5.48		Feb-04
World Bank 9% 13/11/00 RRSP	110.4	111.25	6.62		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	97.1	97.95	6.83		Apr-15
Argentina 8% 5/10/98	99.95	100.8	7.73		Oct-05
Bk. Foreign Eco. Affairs 7% 29/3/96	89.75	90.6	15.75		Mar-29
Kgdm. of Spain (Floating) 29/6/02 (semi)	99.27	99.57	-	4.9375	Dec-29
<b>FINNISH MARKKA DENOMINATED BONDS</b>					
Rep. of Finland 11% 15/6/95	101	101.85	6.51		Jun-15
<b>ITALIAN LIRA DENOMINATED BONDS</b>					
Nordic Inves. Bk 12 3/8% 19/04/96	100.8	101.65	10.84		Apr-19
General Electric 11 1/2% 7/02/95	99.4	100.25	8.32		Feb-07
<b>SWISS FRANC DENOMINATED BONDS</b>					
General Electric 4 3/4% 2/7/98	97.8	98.65	5.17		Jul-02
<b>DANISH KRONE DENOMINATED BONDS</b>					
Kgdm. of Denmark 9% 15/11/96	101.35	102.2	7.69		Nov-15
<b>ECU DENOMINATED BONDS</b>					
United Kingdom 9 1/8% 21/02/01	102.1	-	-		Feb-21
<b>BRITISH POUND DENOMINATED BONDS</b>					
Kgdm. of Sweden 8 3/4% 29/5/96	100.15	101.00	7.92		May-29
<b>FRENCH FRANC DENOMINATED BONDS</b>					
Credit Lyonnaise 9 1/2% 23/12/96	102.5	103.35	7.62		Dec-23
<b>JAPANESE YEN DENOMINATED BONDS</b>					
World Bank 5 3/4% 7/8/96 RRSP	103.65	104.5	2.84		Aug-07
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>					
Ontario Hydro 10 7/8% 8/01/96 (semi)	101.75	103.25	7.53		Jan-08
Eksportfinans 7 3/4% 5/11/97	95.95	-	-		Nov-05
Royal Bank of Canada 9 1/8% 7/11/97	99.1	100.6	8.78		Jan-07
<b>SOUTH AFRICAN RAND DENOMINATED BONDS</b>					
ESCOM 12% 1/5/96 (semi)	95.85	96.7	14.82		May-01
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>					
Commonwealth Bk. of Australia 9 3/4% 15/5/96	98.65	-	-		May-15
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>					
New Zealand Gov't 10% 15/7/97 (semi)	101.15	102	9.10		Jan-15
New Zealand Gov't 8% 15/7/98 (semi)	96.4	97.25	8.91		Jan-15
Fletcher Challenge 10.75% 15/12/97 (semi)	98.65	99.50	10.95		Dec-15
Fletcher Challenge 10.15% 30/11/98 (semi)	97.25	-	-		Nov-30
Corporate Investment Ltd. 13 1/2% 19/6/95 (semi)	81.3	83.8	39.81		Dec-19
Tranz Rail Ltd. 10% 15/10/99 (semi)	97.3	98.15	10.49		Apr-15
DB Group 7% 30/6/96 (semi) matures @ 85	82.85	83.7	10.87		Dec-30
<b>ARGENTINEAN PESO DENOMINATED BONDS</b>					
BIC V Fixed/Floating 1/5/2001 Callable in full on every interest date	67.3	68.15	18.46		4th day of mth.
<b>U.S. DOLLAR DENOMINATED FIXED CONV. BONDS</b>					
Burnup & Sims 12% 15/11/00 CV@16.79 p/sh (semi)	94.25	95.75	13.05		May-15
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh	53.25	54.75	16.21		Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh	82.25	83.75	9.08		Jun-10
Glycomed 7 1/2% 1/1/03 CV@14.06 (semi)	52.25	53.75	18.95		Jan-01
California Microwave 5 1/4% 15/12/03 CV@28.44 p/sh (semi)	117.75	119.25	4.50		Dec-15
<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>					
Farm Credit Corp 7 3/4% 10/06/96 RRSP	100.3	101.15	6.84		Jun-10
T.W.A. 10% 3/11/98 (semi)	53	54.5	31.02		Feb-01
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>					
Kgdm. of Denmark 25/3/97 (Gold call, JY put), (semi)	96	97	-	5.84	Mar-25
United Kgdm. 30/9/96 3 mo. LIBID-1/8 (qly), callable @ 100	99.77	100.07	-	5	Dec-30
Bocon 1/4/01 (30 day LIBOR) starts accruing May 1, 1997	81.3	82.15	16.71		May-01-97
Argentina: Series L.FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	69.625	70.625	14.49	6.5	Mar-31

**GOLD** (in ounces, at market prices, can also be held in your bond account client eligibility determined at point of sale.

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