

THE BOSTON CONSULTING GROUP

The 2006 Value Creators Report

AUSTRALIAN SUPPLEMENT



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NICHOLAS GLENNING

JAMES GOTH

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Any inquiries concerning the themes explored in this report or the material it contains should be directed to:

The Boston Consulting Group
Level 28 Chifley Tower
2 Chifley Square
Sydney NSW 2000
Phone: +61 2 9323 5600
www.bcg.com

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About This Supplement

Since its founding more than 40 years ago, The Boston Consulting Group (BCG) has analysed the drivers of value creation for clients across industries. Our global Value Creators Report series analyses the world's top-performing companies each year in order to build an understanding of what drives the outperformance of leading players across all industries. This report has been prepared as a local Australian supplement to the 2006 global report, '*Spotlight on Growth: The Role of Growth in Achieving Superior Value Creation*', with the aim of analysing the performance of large Australian companies and canvassing specific issues facing Australian managers.

About the Authors

Nicholas Glenning is a Partner and Managing Director in the Melbourne office of BCG and leads the firm's Corporate Development practice in Australia and New Zealand. James Goth is a Partner and Managing Director in the firm's Sydney office.

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BCG's Corporate Development practice area combines BCG's traditional expertise in corporate strategy with extensive experience in mergers and acquisitions and post-merger integration, a proprietary value-management methodology, and new analytic approaches for understanding and responding to the ways that capital markets value a company. We work closely with BCG's industry experts to help clients design and execute their corporate strategies, reengineer their portfolios, screen potential acquisition targets and integrate them after the deal is signed, and make sure that corporate processes are aligned with the goals of the company's value-creation strategy.

For Further Information

For further information on the report and to learn more about BCG's value-management capabilities, please contact:

Nicholas Glenning
Partner and Managing Director
BCG Melbourne
+61 3 9656 2100
glenning.nicholas@bcg.com

James Goth
Partner and Managing Director
BCG Sydney
+61 2 9323 5600
goth.james@bcg.com

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Executive Summary

In The Five Years To The End Of 2006...

Australian companies outperformed most of their overseas peers

- Overall, they achieved an impressive 15.5 percent average annual return to shareholders compared to 6.2 percent in the US, 7.1 percent in the UK and 11.5 percent in Japan
- The continued low volatility of the stock market has resulted in Australian companies outperforming all others in risk-adjusted stock market returns

ASX100 companies in our sample have shown consistently strong performances

- Only one company in our sample¹ showed negative Total Shareholder Return (TSR)
- Overall cash profitability is at an all-time Australian high of 14 percent—all but two sectors have consistently performed well
- Cash flow profitability is a minimum of, and often greater than, 4.9 percentage points higher than the comparable global sample for the period
- \$363b growth in fundamental value has been generated—this is driven by the Resources, Real Estate/Infrastructure and Banks sectors which generated \$243b, or two-thirds, of the total value
- Market gains have been driven by fundamentals such as strong cash generation and profitability and an expectation of continuing good future performance
- High expectations for future value creation are reflected in consistent and resilient Expectation Premiums

Increasing private equity activity in the Australian market has affected the level of market valuation, but in a relatively targeted fashion

- ‘Classic’ private equity targets (i.e. those with low leverage and high cash

generating ability) have an Expectation Premium three times higher than other companies and in fact have not attracted significant interest from private equity investors. Reducing this premium would account for 11 percent of total market valuation

- Further strengthening cash profitability, or driving improved growth are the two key remaining strategies for companies to create value that accords with their Expectation Premiums

Looking Ahead...

When developing future strategies for creating value, growth will need to be a significant focus for Australian managers

- Increased profitability in an already highly profitable marketplace is likely to be much harder to achieve consistently
- Australian managers will need to increasingly focus their strategies on growth, both organically and through acquisition, in the domestic market and overseas
- About the half the sampled companies have strong multiples and cash flows in excess of domestic growth opportunities, placing overseas expansion on the agenda

Australian managers should consider the following questions:

- What are the expectations for future returns that are embedded in my current share price?
- What are the key trends that will impact my industry, my competitors and my company over the long term?
- What corporate moves could I make now, or in the future, that might set me up for future competitive advantage?
- What are the overseas growth opportunities for my company and my industry?
- What is the true value of returning cash to my shareholders?

¹ See Appendix for definition of our sample.

Preface: Value Creation And The Challenge Of Growth

Australia has now completed its 15th consecutive year of uninterrupted economic growth. Since 1991, real economic growth has averaged 3.6 percent per year. This robust environment has underpinned an equally impressive run of value creation in Australian equity markets—an average 9.2 percent per annum since 1991.

This report takes a closer look at the value creation record of the large Australian companies that have driven this performance. Guided by the techniques and methodology of BCG's Corporate Development practice, it uses detailed analysis of the companies appearing in the ASX100 over the last five years² to shed light on the major trends in value creation in Australian equity markets. Drawing on these insights, the report also discusses some of the key issues likely to face Australian managers as they strive to deliver a repeat performance over the next five years.

The report is structured in the following sections:

The Australian Market Overall. We compare the Australian equity market's performance with that of its peers over the last five years, both at the overall level and by sector. Then, we isolate the sources of that performance: the extent to which share market gains were driven by improvements in fundamental performance versus changes in expected future performance; and the extent to which improvements in fundamental performance were driven by profitability improvements versus investment growth.

A Look Ahead: Focus on Growth. We look at the market's prospects going forward—in particular the apparent positive levels of

expected future growth that continue to be factored into the market's current valuation.

Managing Growth: Issues for Australian Managers. In this section we look at some of the major issues and trade-offs that Australian managers face when thinking about growth and value creation going forward. These include corporate activity in the midst of a Mergers and Acquisitions (M&A) and private equity boom, when and how to pursue offshore growth opportunities, and deciding when to give cash flow back to shareholders.

The 2006 Top-Quartile Performers and Industry Comparisons. These sections apply BCG's 'outside-in' disaggregation tool to companies that posted top-quartile performance over the last five years and to an industry breakdown of the ASX100 performance.

² Given that some of the current ASX100 companies did not exist five years ago, our sample was less than 100 companies. We acknowledge some 'survivor bias' in this approach. A full list of our sample appears in the Appendix.

The Australian Market Overall

In this section, we focus on the aggregate performance of the Australian equities market over the last five years.

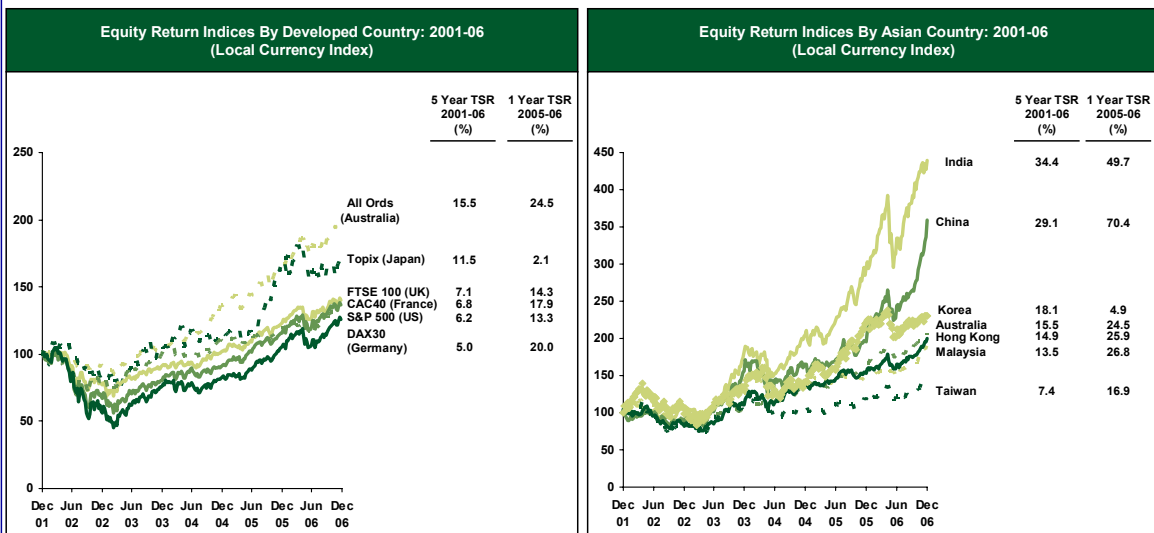
Continuing Strong Returns

The 15.5 percent average annual return to shareholders—or Total Shareholder Return (TSR)³—generated by Australian public companies over the past five years is extremely impressive.

Internationally, the Australian equities market outgrew all major world and Asian indices except Korea, China and India, as shown in Exhibit 1.

Although India and China’s stock market indices outgrew Australia’s, they did so at the expense of greater volatility. Exhibit 2 shows a comparison of risk-adjusted returns by charting both average weekly total returns and the standard deviation of weekly returns for the last five years⁴. On the basis of risk-adjusted returns, Australia’s stock market edges above India’s and China’s to be the highest of all of the world’s major markets, as shown in Exhibit 2.

EXHIBIT 1 AUSTRALIA OUTPERFORMED ALL OTHER DEVELOPED COUNTRY MARKETS AND MANY REGIONAL MARKETS



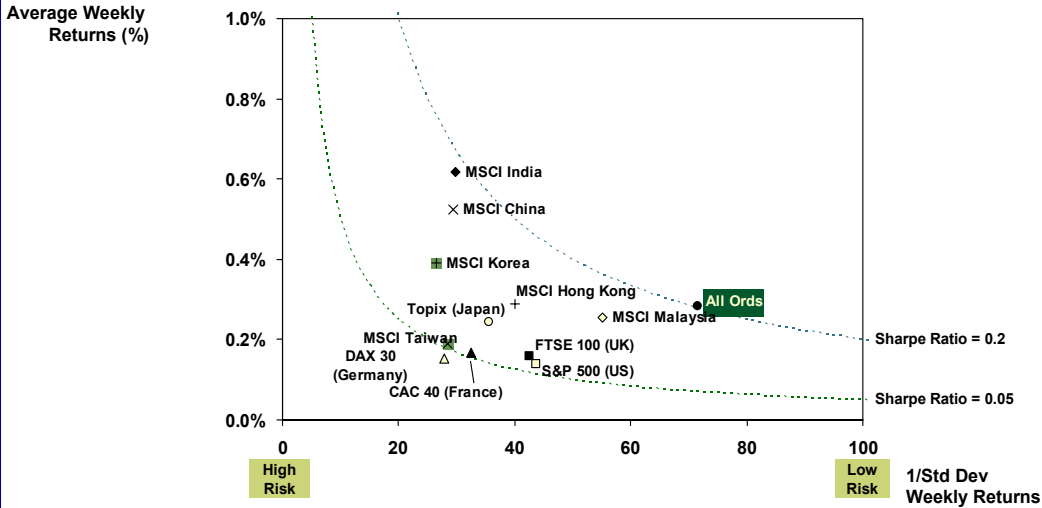
Note: All non-Australian regional indices calculated using MSCI country indices
Sources: Thomson Financial Datastream; BCG analysis

³ TSR comprises share price appreciation and dividend yield.

⁴ This is known as the Sharpe ratio.

EXHIBIT 2
ON A RISK ADJUSTED BASIS AUSTRALIA OUTPERFORMED ALL OTHER WORLD AND REGIONAL MARKETS

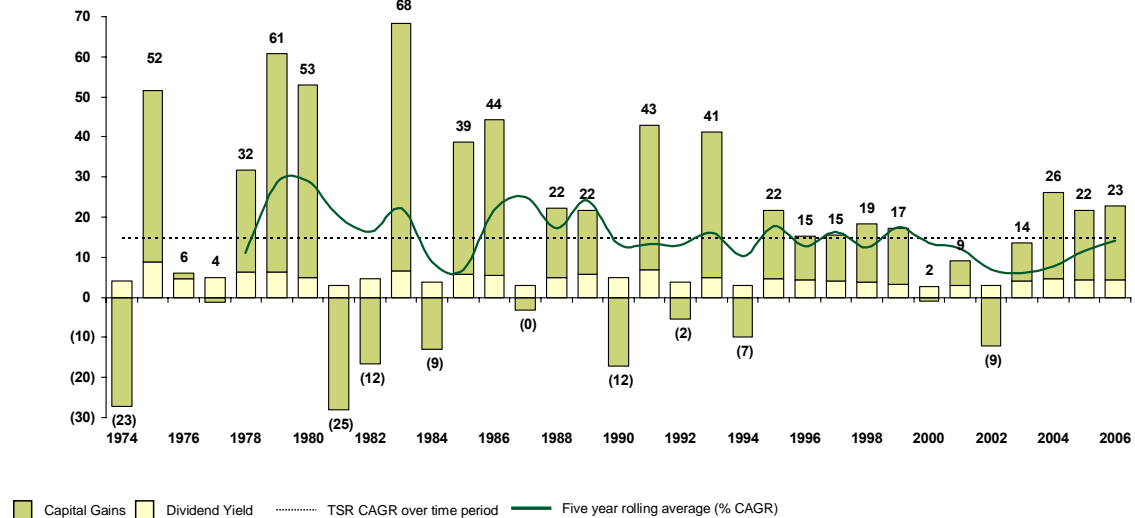
Decomposition of Sharpe Ratio⁽¹⁾ by Country: 2001 - 06



(1) Sharpe Ratio provides a risk-adjusted measure of return. It is calculated as average weekly return multiplied by 1/standard deviation of weekly returns
 Note: All non-Australian regional indices calculated using MSCI country indices
 Sources: Thomson Financial Datastream; BCG analysis

EXHIBIT 3
NOT SINCE '78-'80 HAS THE AUSTRALIAN MARKET HAD THREE CONSECUTIVE YEARS WITH RETURNS GREATER THAN 20%pa

Composition of Australian Equity Market⁽¹⁾ Returns: 1974-06
 (%)



(1) Calculation based on Datastream Australian sharemarket index (DS code: TOTMKAU)
 Source: Thomson Financial Datastream

On an *historical* basis, the 15.5 percent five-year annual return on Australian equities is also impressive. Exhibit 3 illustrates that the TSR over five years has now regained the levels of value creation achieved during the 1990s as shown by the rolling average in the chart. It also shows that 2006 was the first time that three consecutive one-year TSRs have exceeded 20 percent in the Australian market since the late 1970s⁵.

Exhibit 3 also shows the continuing fall in volatility of the Australian stock market performance over the last decade. This continues the trend we discussed in last year's Supplement, concerning the dramatic decline of volatility over the past decade compared to the previous twenty years. As a result, Australian equity investors now require a lower risk premium when they invest in Australian listed companies.

Broadly Based

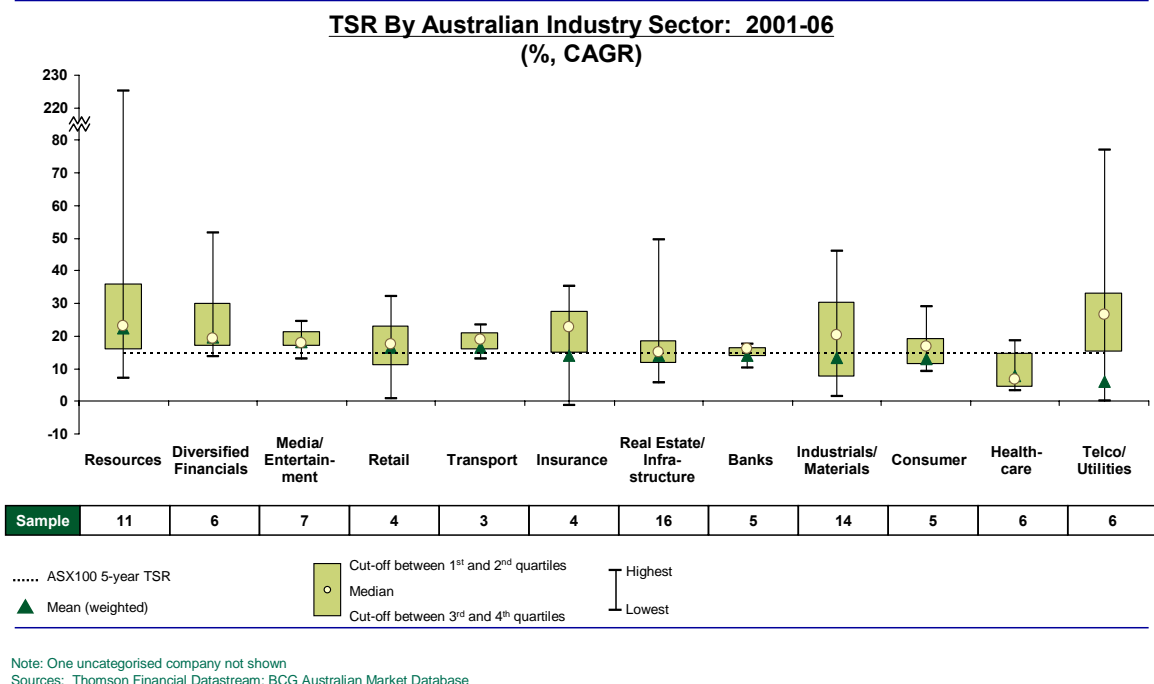
Another noteworthy element of the market's recent performance is the prevalence of strong returns across all sectors. This is displayed in Exhibits 4 and 5.

Exhibit 4 shows each industry's TSR performance and the spread of our sample companies' performance within each industry. Second- and third-quartile performers across all industry sectors had solid double-digit TSR growth over the last five years. Indeed, only one company in our sample showed negative TSR growth over this period.

Exhibit 5 shows that the spread of industry TSR performances has narrowed over recent years.

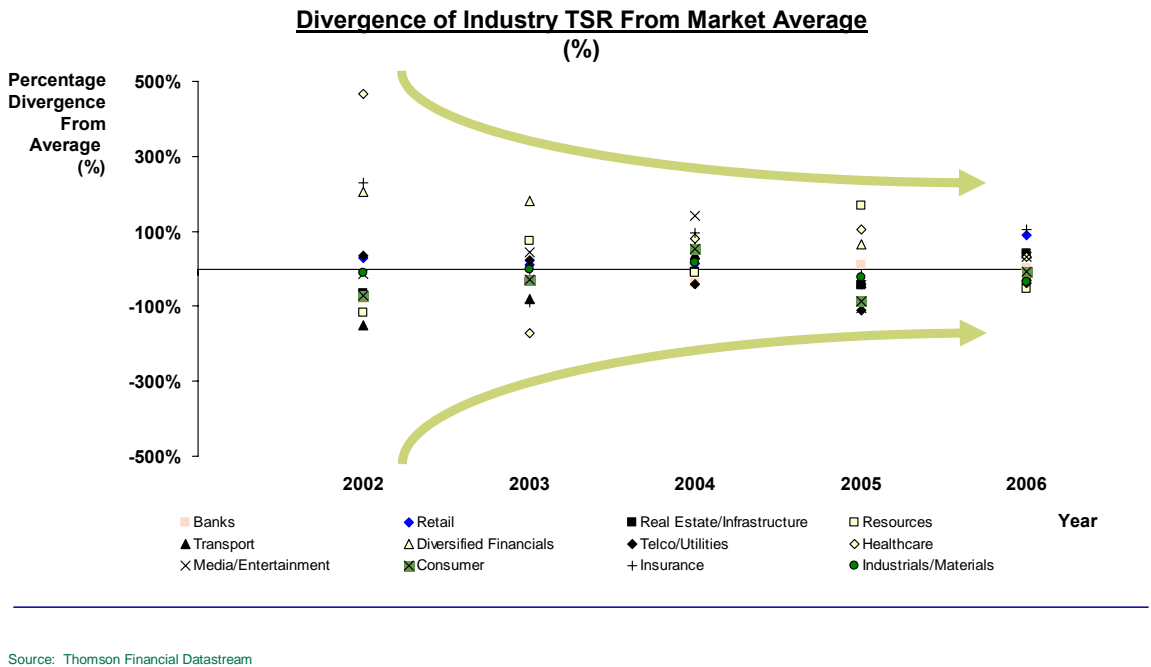
EXHIBIT 4

CONSISTENTLY STRONG PERFORMANCE ACROSS THE BOARD LED BY RESOURCES AND DIVERSIFIED FINANCIALS



⁵The 23 percent 2006 one-year TSR number in Exhibit 3 varies slightly from the 24.5 percent 2006 one-year TSR number in Exhibit 1 due to the use of different data sources.

EXHIBIT 5
INDUSTRY RETURNS HAVE CONVERGED SINCE 2002



Strong Fundamentals

The reduced volatility of the overall market and the lower variation of returns across industries both point to the robustness of the Australian stock market’s recent performance. Another indication of this stability is the strength of the underlying ‘fundamentals’ of value creation.

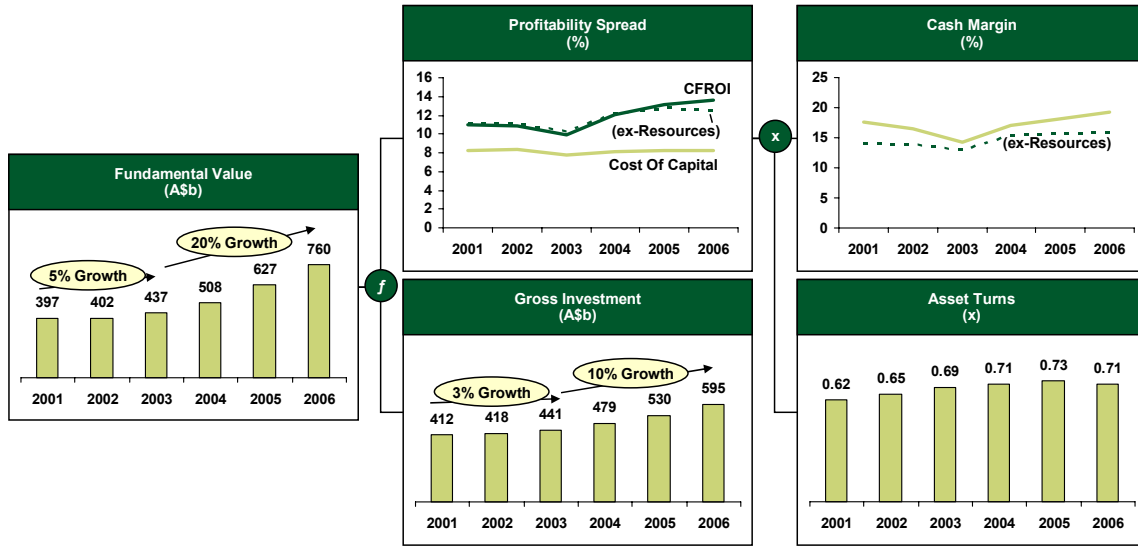
To gauge the fundamentals of a company’s value creation record, BCG uses a proprietary methodology based on the company’s cash flow generation performance. We take into account the cost of capital and the likelihood that current growth and profitability rates will fade back

to an industry average over time.⁶ Exhibit 6 contains our analysis of the drivers of fundamental value for all of the companies in our sample. It shows that from 2001 each of the three main levers for fundamental value creation—cash margin, asset turns and growth in gross investment—improved strongly, particularly since 2003. At 14 percent cash flow return on investment (CFROI), Australian industry is at historically high levels of profitability. Even if the booming Resources sector is excluded, Australian industry cash profitability falls only slightly to 12 percent.

⁶ See the Appendix for a description of our approach.

EXHIBIT 6 INCREASING PROFITABILITY AND STEADY GROSS INVESTMENT HAS DRIVEN FUNDAMENTAL VALUE GROWTH

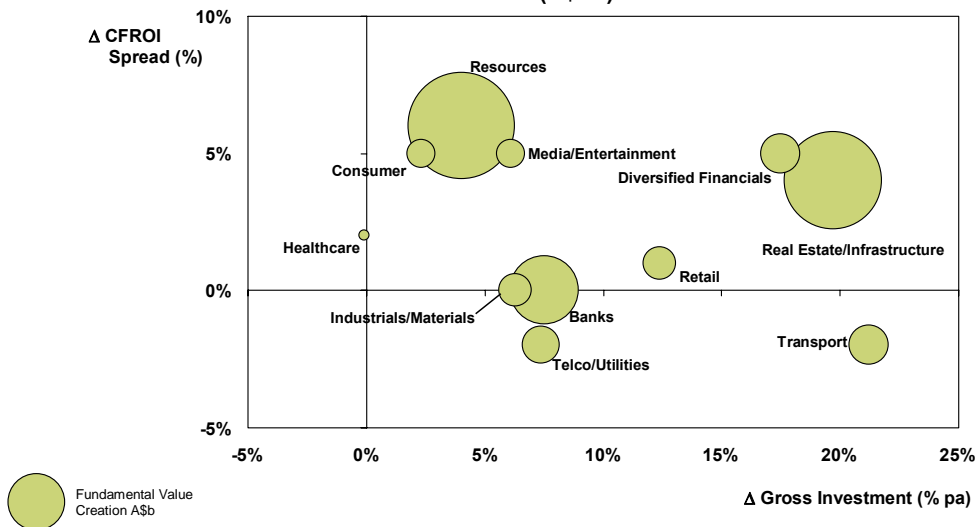
Decomposition of Fundamental Value in the Australian Market: 2001-06



Note: Exhibit based on weighted average data for all companies in sample
Source: BCG Australian Market Database

EXHIBIT 7 RESOURCES, REAL ESTATE/INFRASTRUCTURE, AND BANKING SECTORS HAVE DRIVEN THE BULK OF FUNDAMENTAL VALUE CREATION

Enterprise Value Creation By Industry: 2001-06 (A\$b)



Note: Exhibit based on weighted average data for all companies by industry sector; excludes insurance due to different reporting requirements

Source: BCG Australian Market Database

Exhibit 7 shows the drivers of fundamental value creation across each industry sector over the last five years⁷. Here, growth in cash margin and in asset turns have been summarised into overall cash profitability, or CFROI, and compared to the cost of capital to give a profitability spread. The exhibit shows that over the last five years the corporate sector has performed relatively strongly across industries. All sectors except Healthcare have been growing and all sectors except Telco/Utilities and Transport show stable or improving profitability.

Two-thirds of the \$363b growth in fundamental value generated by our sample over the last five years can be attributed to just three industries: Resources, Real Estate/Infrastructure and Banks.

Each of these industries has adopted a different value creation pathway. Resources, driven by the global boom in commodities prices, has created value through increased profitability rather than growth in the investment base. In comparison, Banks have driven value by steadily growing a large, profitable asset base. Finally, the Real Estate/Infrastructure sector has managed to achieve both strong growth and improving profitability, with its success undoubtedly linked to the acquisition of previously unlisted assets through the use of innovative capital structures. Unsurprisingly, the Diversified Financials sector, which has played a facilitating role for the Real Estate/Infrastructure sector, exhibits a similar value creation path.

⁷ See also the Industry Comparisons section of this report for a more market-focused breakdown of TSR performance by industry.

A Look Ahead: Focus On Growth

The Australian equity market has enjoyed a prosperous five years. But what lies in store for the future? In this section, we take a closer look at the forward prospects for the Australian market.

Continuing Strong Expectations For Future Returns

Our first observation is that current market valuations reflect a belief that forward operating returns will outstrip the returns one might expect based on historical profitability and growth trajectories.

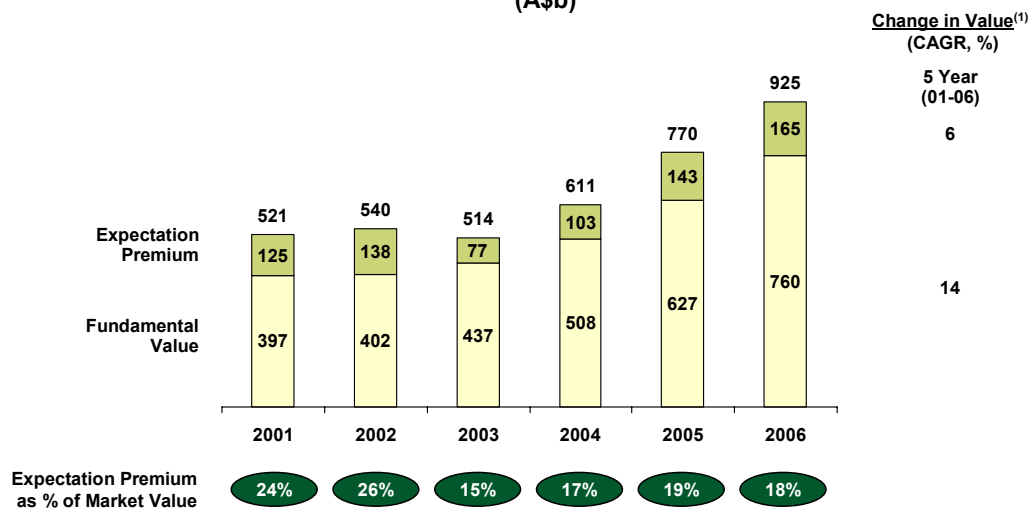
Exhibit 6 showed BCG's estimate of the fundamental value of the stocks included in our sample. Exhibit 8 compares that fundamental value with the value of stocks as measured by the market.

The difference between our estimate of a stock's fundamental value and the market's actual valuation of that stock is what we term the 'Expectation Premium'. While the existence of an Expectation Premium does not necessarily mean a stock (or set of stocks) is overvalued, it does mean that the market is expecting stronger value creation for that stock than is suggested by its current profitability and growth levels and historical fade-to-average trajectories⁸.

It is important to note that it is the resilience, not the size, of the Expectation Premium that is significant. At 18 percent of market value in 2006, the Expectation Premium is actually lower than it was in the early years of this decade, and is marginally lower

EXHIBIT 8 MARKET VALUES CONTINUE TO EMBODY AN EXPECTATION PREMIUM

Fundamental Value and Expectation Premium in the Australian Market: 2001-06 (A\$b)



(1) Does not include dividends or interest
Note: Exhibit based on weighted average data for all companies in sample
Source: BCG Australian Market Database

⁸ See the Appendix for a description of the use of fade assumptions in BCG's valuation methodology.

(by one percent) than our global sample⁹. But after three consecutive years of TSR returns above 20 percent and operating cash flow profitability at an all-time high, it is significant that the market *continues* to expect this level of operating outperformance for Australian companies over the coming years.

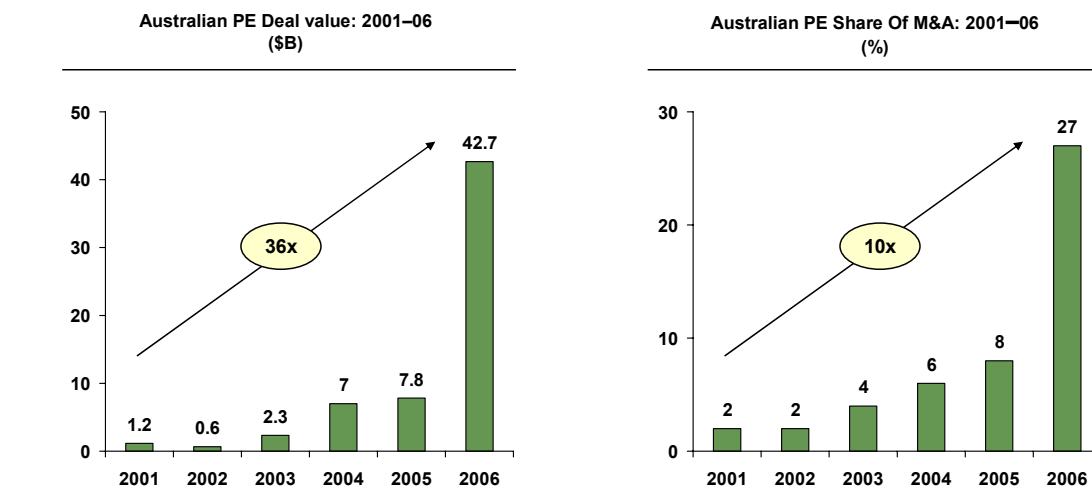
The Impact of Private Equity: Only A Partial Driver of Activity

How much of the current Expectation Premium can be attributed to the spread of private equity in Australia's corporate market?

Exhibit 9 shows that private equity hit the Australian market in earnest in 2006. The value of deals in that year was 36 times higher than in 2001.

Private equity patterns overseas¹⁰, and the ever-increasing amount of fund raisings completed by private equity firms, suggest that private equity activity and interest in Australia is likely to increase further in coming years. It follows that this expectation is likely to feed into market valuations, particularly for those companies considered to be 'classic' private equity targets. Although it is difficult to anticipate the precise impact of these private equity-driven expectations, the analysis in Exhibit 10 provides some indication of the effects. We have categorised the companies in our sample¹¹ according to two fundamental characteristics that private equity investors typically evaluate when picking acquisition targets: cash generating ability; and ability to take on more debt. The bubbles represent the relative market capitalisation of each company in our sample.

EXHIBIT 9 LOCALLY, PRIVATE EQUITY HAS TAKEN OFF



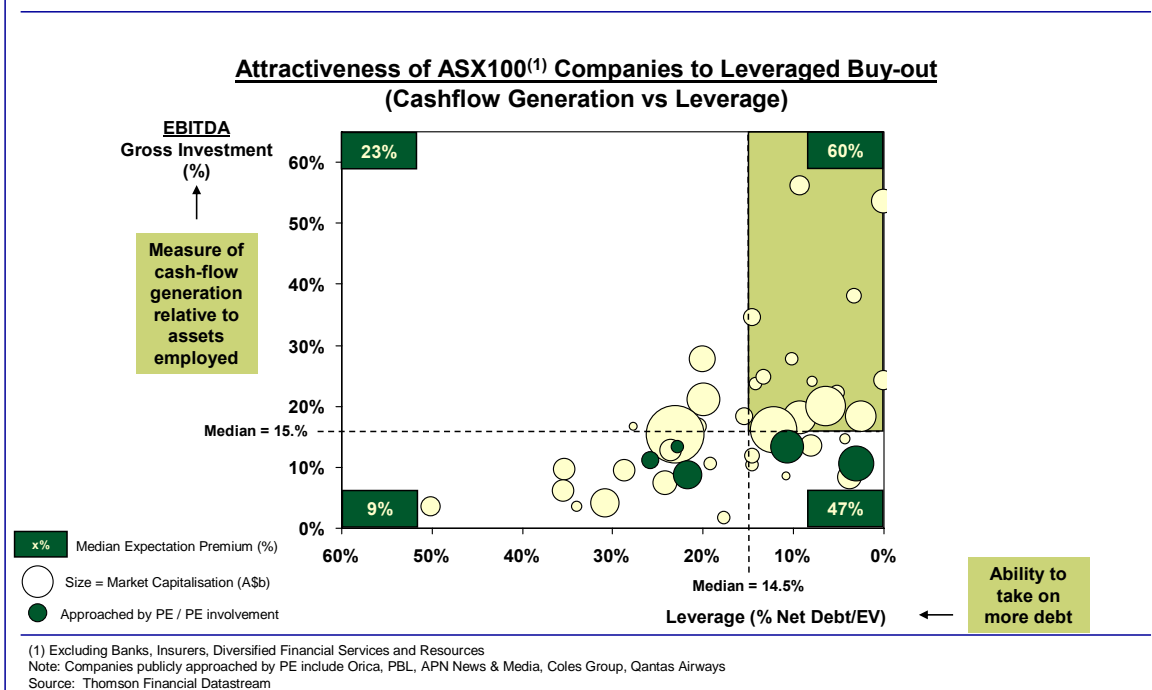
Source: Thomson Financial Datastream

⁹ Our 2006 global report on value creation: 'Spotlight On Growth: The Role Of Growth in Achieving Superior Value Creation', analyses the value creation of the top 1000 publicly-listed companies globally.

¹⁰ In 2006, private equity deals accounted for one-quarter of global M&A activity by value.

¹¹ We excluded Banks from this analysis because of differences in capital structure.

EXHIBIT 10
POTENTIAL PRIVATE EQUITY TARGETS HAVE THE LARGEST EXPECTATION PREMIUMS



Our analysis shows that the subset of companies with both relatively low leverage and relatively high cash-generating ability—the ‘classic’ private equity targets—have a much higher Expectation Premium than the remaining companies: 60 percent versus the market average of 18 percent. We estimate that if this subset of companies had an Expectation Premium similar to the remaining companies, the total Expectation Premium of our sample would be \$146bn, or 11 percent lower.

Interestingly, when we highlight the companies in Exhibit 10 that have reportedly been approached by private equity investors in the last 12 months, we see that very few actually fall into this ‘classic’ private equity target subset. This suggests that the prices of these companies may have been pushed beyond attractive levels for private equity; and/or that private equity investors look beyond simple cash

and leverage measures when selecting acquisition targets, for example looking for turnaround and growth opportunities.

Further Significant Gains From Profitability May Be Difficult

While private equity interest is contributing to the continued strong valuations in the Australian equity market, it is not the only driver of the Expectation Premium. If we strip out an estimate of the impact of a private equity valuation from the premium, the market is still expecting operating returns 16 percent above what historical profitability and growth trajectories forecast. Ultimately, these additional gains can only be met from two sources: greater profitability, or stronger growth.

If we turn first to profitability, there are signs that additional gains—at least on a macro level—may be difficult to achieve.

Exhibit 11 shows Australian cash flow profitability historically and compares current global levels by industry. On an historical basis, we see in the left hand side of the exhibit that the 14 percent CFROI posted by our sample in 2006 is the highest since our Australian Supplement series began in 1998, and is more than one-third higher than it was then. This historically high level of profitability accords with the current historically high share of profits in the Australian economy¹², the buoyant macroeconomic environment, and the flow through of far-reaching micro economic and labour reforms from the 1980s and 1990s.

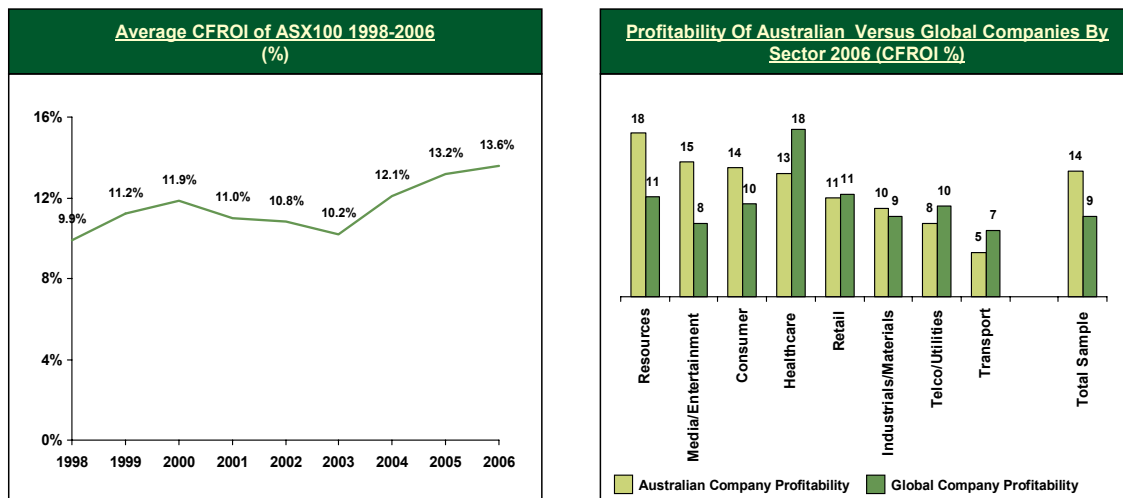
The right side of Exhibit 11 shows the high levels of profitability in Australia compared to the companies in our global sample. Overall, absolute cash flow profitability in Australia is 5 percentage points higher than

for the global sample¹³. This differential is particularly evident in the Resources, Consumer and Media/Entertainment sectors.

We believe it will be difficult to improve, or even maintain, these high levels of profitability over future years. We do not doubt that there will always be initiatives that individual companies can—and must—undertake to improve cost and revenue efficiencies, and that recent and future economic reforms will continue to provide the platform for further productivity gains in the Australian economy. However, we are also acutely aware that over time, competitive forces and increasing supply side costs tend to drive profitability levels back to longer term averages.

EXHIBIT 11

PROFITABILITY IS AT RECORD HIGH LEVELS BY BOTH HISTORICAL AND GLOBAL STANDARDS



Note: The global Value Creator's report did not include Banks, Insurance, Diversified Financials or Real Estate/Infrastructure companies
Sources: BCG Australian Market Database, BCG Global Market Database

¹² See for example 'Output, Expenditure, Activity and Financial Conditions Indicators for the Australian Economy', Reserve Bank of Australia Chart Pack, April 2007.

¹³ On the basis of cash flow spread, which measures the difference between profitability and the cost of capital, Australia's differential from the global sample is even more pronounced: Australian companies have a positive spread of 5.3 percent, whereas the average of our global sample is slightly negative at -0.2 percent.

Focus On Growth

In this context, we see a difficult task ahead for Australian managers. Cost, productivity and revenue initiatives will remain as important as ever for maintaining competitive position. However, with current high levels of operating profitability, Australian managers may find their company's valuation multiple falling despite delivering apparently healthy operating results, as investors begin to discount the sustainability of returns.

In such an environment, growth will be the increasing focal point for managers. We will now consider some implications of this conclusion for Australian managers.

Managing Growth: Issues For Australian Managers

What might a renewed focus on growth mean for Australian managers?

In this section, we discuss three issues which will become increasingly important for corporate Australia in a climate of strong operating performance and continued market expectations:

- Deciding how and when to engage in corporate activity;
- Determining how to pursue overseas growth opportunities; and
- Managing the trade-off between investing, acquiring and returning cash flow back to shareholders.

The M&A and Private Equity Boom: Deciding How To Play

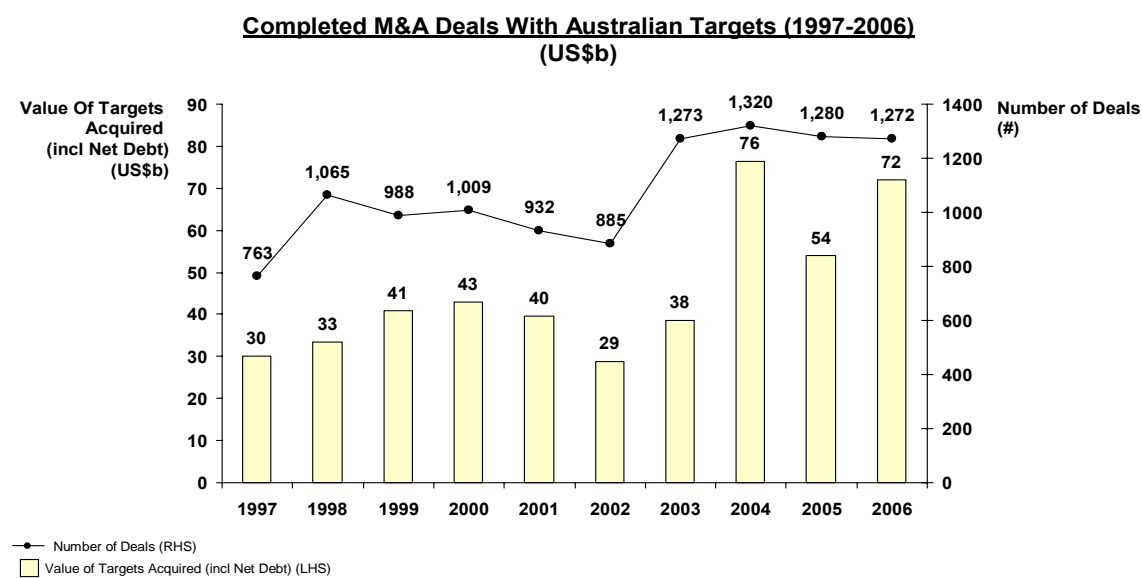
The continued high Expectation Premium in the Australian equity market means that corporate activity is likely to remain buoyant in the near future, maintaining or even eclipsing the historic highs reached in the last four years (as shown in Exhibit 12).

Further, as we noted in the previous section, an increasing amount of this activity is being driven by the growing impact of private equity on the Australian market. With ever-increasing fund sizes, less restrictive mandates and continued access to relatively cheap debt with favourable covenant terms, we expect private equity's influence on the corporate landscape to remain strong.

Whether a suitor is a private equity firm or a competitor with a high valuation multiple, every Australian manager needs to keep corporate activity high on their agenda. All companies are potential targets, and often the best defence is attack. In such an environment, Australian managers will find themselves devoting more and more attention to M&A. In the remainder of this section, we describe some key points for managers to keep in mind as they manage for growth.

Without trying to be exhaustive, some points for managers to keep in mind are:

EXHIBIT 12
THE LAST FOUR YEARS HAVE SEEN A STEP-CHANGE IN M&A ACTIVITY IN AUSTRALIA



Source: Thomson One Banker

Ground your thinking in strategy: To successfully navigate through the M&A jungle it is vital to avoid letting the urgency or thrill of the deal lead to rash decisions. Executives need to ensure that corporate activity considerations are incorporated into the broader strategic agenda of their company. In short, deals should not drive strategy – strategy should drive deals. For this to happen, every company needs to ensure that it has a broad, long term view of its industry’s prospects. Being able to answer questions such as: “What are the forces that are driving underlying trends in my industry?”; “What are the possible end games?”; and “What are the future sources of competitive advantage?” will position managers more strongly to target and/or accept better deals. A more thorough discussion of the importance of industry landscaping can be found in a recent BCG publication *A Matter Of Survival*¹⁴.

Think creatively about business boundaries: The advent of internet technology and the new economics of information in the 1990s led to a radical rescoping of the possibilities of industry and company boundaries¹⁵. Innovative companies found that they were able to ‘deconstruct’ traditional industry value chains, creating niche businesses that were previously unsustainable on a standalone basis, or extending existing businesses into orchestrator roles that sat across multiple industries.

Although we saw the same trends in Australia, the smaller size of the local market has meant that much of the potential for significant reshaping of industry boundaries is yet to be realised. In our view, one important impact of the rising role of private equity in the local market may be to provide additional impetus for this

reshaping to occur. This is because private equity creates greater depth in the market for asset acquisitions and divestments. Previously, a company may have been wary of putting an asset or business onto the market because there was only one natural buyer—often its major competitor. However, the increased presence of private equity creates extra buyer tension that makes companies more willing to part with non-core assets. Likewise, private equity’s willingness to split assets of purchased companies in new ways will also result in changes in industry boundaries.

In such an environment, emerging opportunities can be spotted and exploited by managers who allow themselves to think creatively about new business models and industry boundaries.

Don’t be scared to be aggressive: M&A deals can go wrong. This may be due to poor (or no) fit with strategy, poor negotiating, or insufficient attention to the post-merger integration process. Indeed, many studies that look at the short term impact (typically one to two years) of M&A deals conclude that over half of the deals actually destroy value.

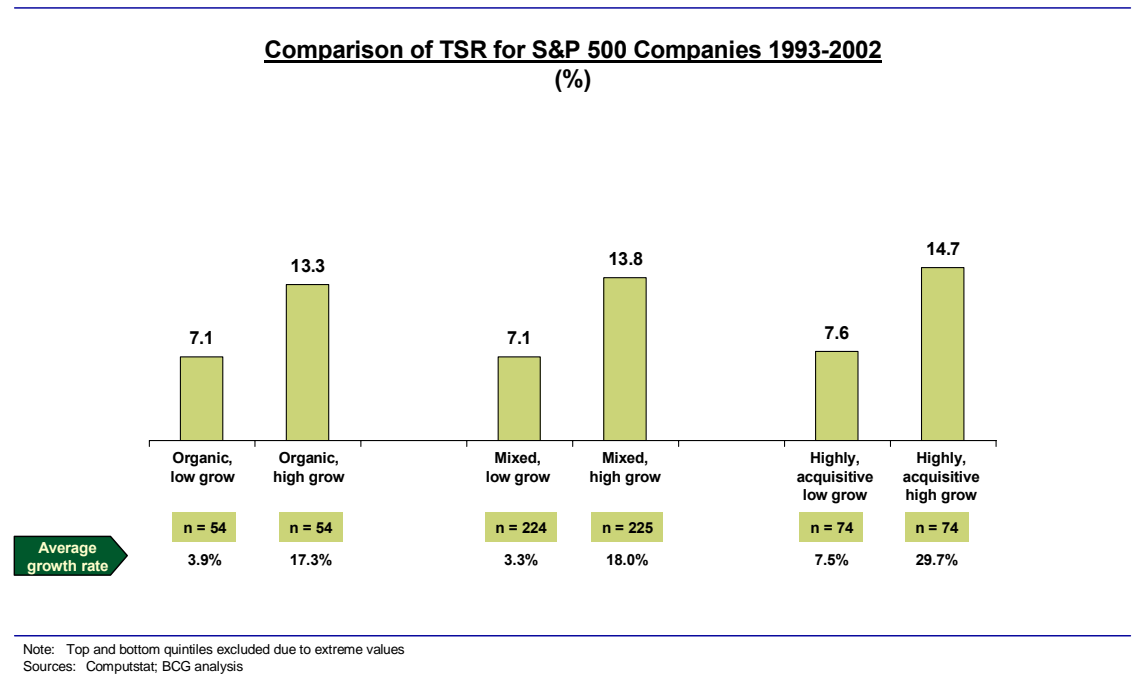
However, over the long term, a different picture can emerge. A BCG study of the US market over a ten-year timeframe showed that despite the fact that deals often do go wrong and fail to create value in the short term, companies which are highly acquisitive and who grow aggressively actually create higher shareholder returns over time than companies that pursued only organic growth or a mixture of organic and acquisitive growth. The results of the study are shown in Exhibit 13.

¹⁴ Available for download from <http://www.bcg.com/publications/files/MatterofSurvivalJan07.pdf>.

¹⁵ See the BCG publication ‘Strategy and the New Economics of Information’ Philip Evans, Thomas S. Wurster, (available for download from : http://www.bcg.com/publications/files/Strategy_New_97.pdf

EXHIBIT 13

US EXPERIENCE SUGGESTS THAT HIGH-GROWTH COMPANIES FARE BETTER EVEN WITH A HIGHLY ACQUISITIVE STRATEGY



The findings of the study do not mean that all companies should become highly acquisitive. Rather, it suggests that companies that actively try to grow and shape the industry landscape can gain advantage, especially if their M&A approach is driven by their broader strategic view.

Overseas Growth: Not If, But How?

For some companies, M&A activity will be the mechanism through which they can match shareholders' expectations for strong future growth. But organic growth will also be key for many companies, and indeed for the Australian corporate sector as a whole. Where local profitability and cash flow growth rates outstrip underlying demand growth within Australia, many Australian companies will find themselves increasingly turning to overseas growth opportunities to plug the growth gap. We estimate that for almost half of the companies in our sample, current cash flows (net of dividends) outstrip analyst forecasts of organic growth.

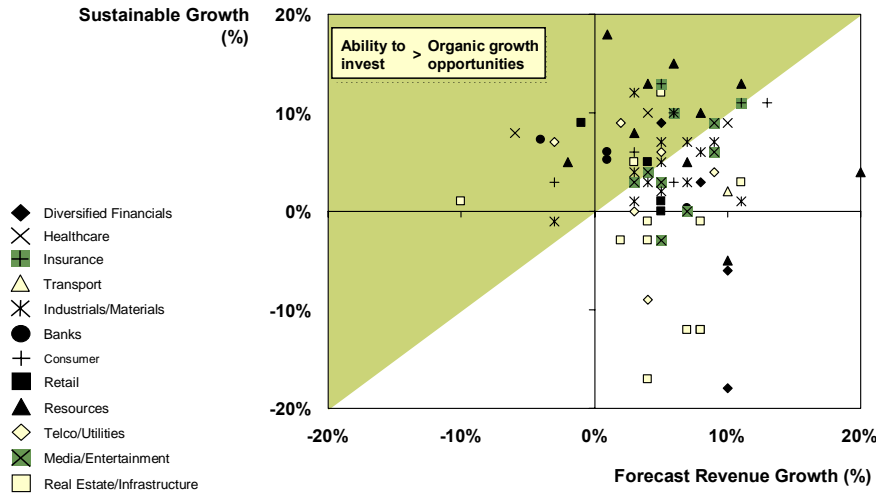
This is shown in Exhibit 14. The pursuit of overseas growth opportunities creates a new set of issues and challenges for many Australian managers. In particular, they can expect to face a great deal of opposition and scepticism from boards and analysts who will remember failures from corporate Australia's last major foray into international growth in the 1990s.

In dealing with such issues, and in mapping out international growth strategies, some points that Australian managers should keep in mind are:

Learn from recent Australian success stories: Over the last five years we have witnessed a new wave of Australian corporate international success stories. In sectors as diverse as Real Estate/Infrastructure, Resources and Healthcare, Australian companies are reaching the forefront of global industry success. Exhibit 15 shows that overseas revenue now comprises a significant proportion of total revenue in the majority of ASX100 industry sectors, and one-quarter of revenues for the overall sample.

EXHIBIT 14
ALMOST ALL INDUSTRIES HAVE COMPANIES FACING A GROWTH DILEMMA

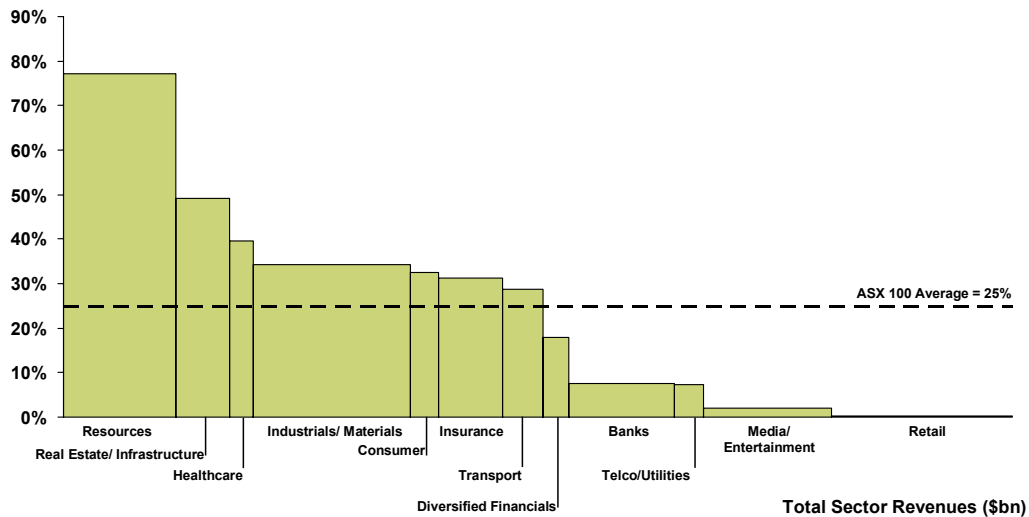
Comparison of Sustainable Growth Rates vs Forecast Revenue Growth 2006
 (%)



Sources: IBES Consensus Analyst Revenue Growth Forecast; BCG analysis

EXHIBIT 15
GLOBAL REVENUES ACCOUNT FOR A SIGNIFICANT PROPORTION OF TOTAL REVENUES FOR MANY SECTORS

Proportion Of Sector Sales Revenue From Global Sources 2006
 (%)



Sources: The Diplomat 'Global 100' 2007; BCG Analysis

It is not just the proportion of global revenues that is impressive for these ASX100 companies, but also the way in which it is occurring. Some of these companies are not just succeeding overseas, but are actually starting to shape their industry landscapes on a global basis, successfully transplanting capabilities and business models innovated in Australia to the global stage. This is especially the case in areas such as Real Estate/Infrastructure and Diversified Financials, where Australia's early deregulation of financial markets and mandated superannuation flows created the right conditions for leading edge business models to emerge.

For Australian managers who want to embark on an international growth path, these trail-blazing success stories are both encouraging and edifying. They demonstrate that Australian companies can succeed on the world stage (despite the oft-mentioned tyrannies of distance and lack of size) if they can get some key things right. First they need to master their local domains, then build the basis of real and often unique sources of competitive advantage and finally, they need to think carefully about where and when those advantages can be transplanted elsewhere.

Learn from the BRICs¹⁶: Australian companies considering overseas growth strategies will typically also look to established leading global companies in their industry for lessons learned and blueprints. While this is a valid practice, it can be unnecessarily narrow. BCG has observed a new breed of global challengers emerging from rapidly developing economies, whose experiences and blueprints for international expansion are more recent and in many respects more relevant for Australian companies than long-established industry leaders based in developed economies.

The overseas expansion strategies and lessons of this new breed of challengers are

discussed in a recent BCG publication, *The New Global Challengers¹⁷*. That publication, which analysed the 100 top companies from rapidly developing economies showed there are multiple paths to success. Cemex, for instance, built unique capabilities and a highly scalable business model in its native Mexico, and then grew the model quickly throughout the world with a series of acquisitions and a rigorous approach to running integrations. Other challengers have relied more upon organic growth overseas (indeed, only 20 percent of the sample companies' growth came from M&A) and on building and investing in overseas supply-chain-management capabilities.

Regardless of their different paths, this new breed of global challengers successfully overcame common issues in a way that is instructive for Australian managers facing similar hurdles. The challengers each realised the need for clear, long-term globalisation targets and roadmaps, as opposed to an opportunistic approach to overseas growth. They also recognised how essential it is to have a globally capable management team that includes a healthy proportion of foreigners. And each felt the need to redesign their entire organisations to be truly global, making difficult decisions regarding the centralisation or decentralisation of various key functions and the extent to which the company organises geographically rather than by business line.

¹⁶ Brazil, Russia, India, China.

¹⁷ Available for download from:
http://www.bcg.com/publications/files/New_Global_Challengers_May06.pdf.

Capital Management: Invest v Acquire v Return

We end this section on a cautionary note. Although Australian managers need to be aware of the expectations for growth embedded in today's market valuations, and to push their management teams to think creatively and aggressively about growth opportunities, these considerations should never obscure the basic premise of value creation: that at the end of the day, all decisions, including decisions about growth opportunities, must drive to long-term shareholder value creation.

Over the course of the last decade, Australian companies have made great strides in becoming more sophisticated regarding the evaluation of growth opportunities, implementing rigorous processes to review capital expenditure and acquisition decisions. Most now employ advanced techniques to quantify the risk of a project and to explicitly take into account the cost of capital (i.e., alternative use of the cash) when evaluating new opportunities. As a result, fewer and fewer investment and growth projects are entered into that lack the ability to earn returns above the cost of capital.

Yet earning above the cost of capital is not necessarily sufficient to green-light a growth opportunity, even from a full financial point of view. As pointed out in the 2006 global *Value Creators Report* that this report supplements, it is not necessarily true that all growth investments delivering returns above the cost of capital actually create value. Why? Because the market may not place the same value on the investment that management has. This may be because the company's specific investor base has different priorities than those assumed by management. For example, they may be predominantly value investors who do not welcome growth ventures that are overly risky. Or it may be because the growth project potentially compromises other metrics that investors hold to be more crucial in valuing companies in that industry. For example, in consumer branded

industries, growth that sacrifices gross margin tends to be penalised by the market because it is perceived as a weakening in brand strength—hence of future earning potential—even where the overall impact on earnings per share is positive.

In these two examples, a growth initiative that has positive net present value can actually destroy shareholder value, because of its impact on the company's valuation multiple. In both cases, the company may have been better off returning the cash to shareholders—through an increase in dividend payout ratio, a special dividend or a buyback¹⁸ rather than investing in growth¹⁹.

A Checklist For Action

So what are the implications of successfully managing growth for Australian managers? Although there are no easy, universal answers, Australian executives can ask themselves and their management teams some critical questions to understand the impact on their business, including:

- What are the expectations for future returns embedded in my current share price? When I compare them to the returns that my current plan is likely to deliver, is there a gap?
- If a gap exists, what options do I have to fill it? Which pathway will be most valued by my shareholders?
- Where does my company sit in the corporate activity landscape? Who is likely to target my company and why? Do I understand why my company is valued at a higher or lower multiple than my peers?
- What are the key trends that will affect my industry and my company over the long term? How will these change the basis for advantage in my industry? What corporate moves could I make now, or in the future, that might set me up for future

¹⁸ See last year's Australian Supplement for a discussion about the choice between dividends and buybacks.

¹⁹ Additional considerations, such as the level of taxability of dividends, should also be taken into account.

advantage? How are my competitors likely to be answering these same questions?

- What are the overseas growth opportunities for my company and my industry? Are there countries whose companies are more likely to build global advantage than others? Why? What sources of global advantage do I have, or can I build or acquire?
- What is the value of returning cash to my shareholders? Are my internal procedures for evaluating growth options biased? What is the best way to translate the strategic value of growth into my evaluation process?

The 2006 Top-Quartile Performers

To identify the top local performers, we sorted the companies in our sample into four quartiles of performance over the last five years.

This year, the threshold to join the top quartile was five-year TSR performance of 24 percent per annum, or around 12 percent above the long-run ASX100 average. This latter number is relatively high compared to the 8 percent outperformance threshold over the last 15 years.

Exhibit 16 lists the companies that were top-quartile performers over the last five years. There is a far more even spread of companies across industries than last year's group, which was dominated by Resources and Industrials/Materials. It is also interesting to note that each of the four new entrants to this year's sample—Paladin Resources (229.3 percent per annum—the top performer), Allco Finance Group (71.3

percent), United Group (46.1 percent), and ABC Learning Centres (29 percent)—have achieved top-quartile five-year performance. This is consistent with our observation in last year's report that it appears easier to achieve higher TSR results from a smaller base. That observation is also supported by the fact that this year, only three of the top-quartile companies by *size* achieved the top-quartile ranking by performance.

Four out of the top five TSR performers over five years also feature in the top five of the one-year TSR performers for 2006: Paladin Resources (350.6 percent over one year), Oxiana (84.9 percent), Macquarie Goodman (68.6 percent), and Allco Finance Group (63.8 percent) join CSL (55.5 percent) as the top performers over one year.

EXHIBIT 16
TOP QUARTILE PERFORMERS IN THE LAST FIVE YEARS: 2001-06

Rank	Company	Industry	5-year TSR 2001-06 (pa)	5-year RTSR 2001-06 (pa)	Market Value (A\$m, 31 Dec 06)	1-year TSR 2006	2005 Rank
1	Paladin Resources	Resources	229.3	168.9	4,458	350.6	N/A
2	Caltex Australia	Telco/Utilities	76.9	66.9	6,210	21.6	4
3	Oxiana	Resources	71.3	39.9	4,390	84.9	1
4	Allco Finance Group	Diversified Financials	51.7	26.9	4,275	63.8	N/A
5	Macquarie Goodman Group	Real Estate/Infrastructure	49.4	31.0	12,614	68.6	2
6	United Group	Industrials/Materials	46.1	29.0	1,930	25.0	N/A
7	Newcrest Mining	Resources	45.5	18.8	8,805	8.7	6
8	Onesteel	Resources	39.8	14.1	2,684	45.7	10
9	Sims Group	Industrials/Materials	35.7	19.9	2,536	22.2	13
10	QBE Insurance Group	Insurance	35.1	18.4	23,616	52.0	36
11	Alinta	Telco/Utilities	35.1	27.4	5,833	12.1	9
12	Australian Stock Exchange	Diversified Financials	33.6	11.7	6,515	23.7	20
13	Orica	Industrials/Materials	32.8	17.3	7,550	22.8	11
14	Metcash	Retail	32.0	13.2	3,596	7.0	3
15	Centro Property Group	Real Estate/Infrastructure	29.2	13.3	7,458	51.0	23
16	ABC Learning Centres	Consumer	29.0	14.2	3,323	19.2	N/A
17	Origin Energy	Telco/Utilities	27.3	20.1	7,086	12.7	12
18	Woodside Petroleum	Resources	26.6	3.4	25,407	-0.6	21
19	AGL Energy	Telco/Utilities	25.9	18.8	6,100	37.5	62
20	Oil Search	Resources	25.2	2.2	3,751	-6.0	25
21	AXA Asia Pacific	Insurance	24.9	9.4	12,708	46.9	50
22	West Australia Newspaper	Media/Entertainment	24.4	5.2	2,444	49.0	47

Sources: Thomson Financial Datastream; BCG analysis

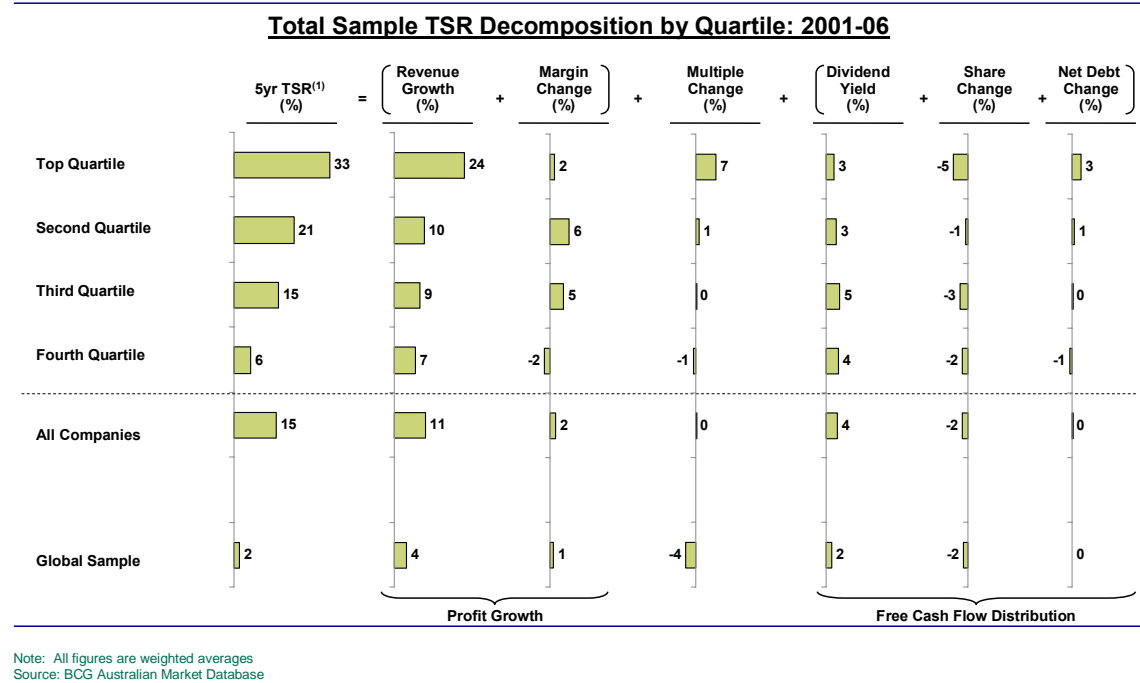
What Sets The Top Quartile Apart?

To investigate what drove top-quartile performance for the five-year period, we undertook a simple market-based breakdown of the drivers of TSR. The results are shown in Exhibit 17, which splits the TSR of each performance quartile into the components driven by increased profits, the change in valuation multiple, and the free cash flows returned to investors²⁰.

As this exhibit shows, the most striking differentiating factor of top-quartile companies' TSR performance has been their ability to grow revenues strongly: top-

quartile companies averaged 13 percent more revenue growth per annum than other companies in our sample. And despite this strong revenue growth, top-quartile performers managed to achieve a positive free cash flow over the period: they did raise new equity, but also managed to pay dividends and pay down debt. Finally, the contribution from improved expectations of future performance (as captured by the increase in valuation multiple) was also a significant factor in these firms' outperformance.

EXHIBIT 17
SUPERIOR REVENUE GROWTH AND MULTIPLE INCREASE DISTINGUISH THE TOP QUARTILE



²⁰ See the Appendix for a discussion of how this 'outside-in' approach differs from the fundamental value approach to disaggregating TSR.

Industry Comparisons

Exhibit 18 shows a similar ‘outside-in’, or market-based, decomposition of the TSR performance of our sample, this time disaggregated by industry.

While every industry sector’s TSR has been positive—and relatively tightly spread—the drivers of TSR have differed significantly by industry.

Resources, the top-performing sector over the last five years with an average 23 percent per annum TSR, has achieved its success not simply by growing revenues (revenue growth of 9 percent per annum is modest compared to some other industries), but also by returning money to shareholders in the form of dividends, share buybacks and through paying down debt.

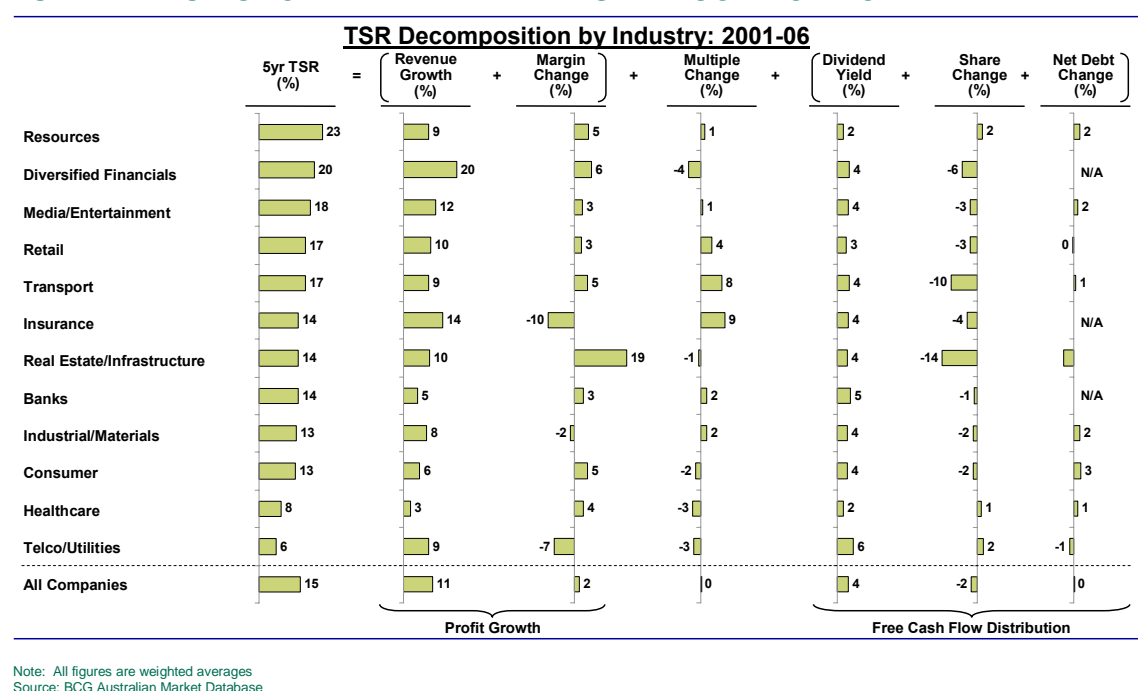
By comparison, Diversified Financials like Macquarie Bank have grown revenues by rapidly expanding innovative

business/financing models domestically and globally, and developing new asset classes supported by the buoyant equity market conditions.

Insurance and Transport companies have benefited from positive changes in valuation multiples, with the Insurance sector also showing rapid growth but facing margin pressures as the pricing cycle turns. By contrast, Real Estate/Infrastructure is the only industry in which margin improvement is a significant factor in value creation. To a large extent this reflects the scale economies of these businesses that enables, for example, growth in securitisation of assets within vehicles with a relatively fixed cost base. Investors however, have funded much of this growth and cumulative free cash flows are yet to turn positive.

EXHIBIT 18

MAGNITUDE OF TSR DRIVERS DIFFERS SIGNIFICANTLY BY INDUSTRY BUT REVENUE GROWTH AND DIVIDENDS ARE COMMON TO ALL



Concluding Thoughts

Clearly, Australian companies have excelled at value creation in recent years, an achievement of which Australian managers and policy makers should be extremely proud. Yet success brings its own demands, and the market's expectations for local companies' remains undiminished.

The managers who succeed in coming years will be those best able to meld innovation and creativity to drive growth with the disciplines of strategy and cash flow value creation. Our aim in this report, as with each year's Australian supplement to the global Value Creators series, has been to canvass some of the key issues that Australian managers need to address if they want to chart this course to success. We hope this report provides the basis for fruitful discussion with executive teams and gives further clarity to the levers available for ongoing value creation.

Appendix: Methodology and Sample

What is meant by fundamentals?

The two basic drivers of value creation are profitability and growth. Profitability is measured by the difference between cash flow returns on investment (CFROI) and the weighted average cost of capital (WACC); this is often referred to as the economic spread. Growth is measured in terms of total gross investment.

These two drivers of value come together in the form of cash value added (CVA), a type of economic profit. The change in CVA is a measure of internal value creation—over the long term, it is more highly correlated to TSR than other accounting-based measures such as earnings per share (EPS) growth.

What is 'fundamental value'?

BCG calculates the fundamental value of a company based on its current performance and a sustainable growth rate. The calculation is a capitalisation of the estimated future economic profits, similar to a Discounted Cash Flow (DCF) analysis, except that BCG's method does not rely on a terminal value.

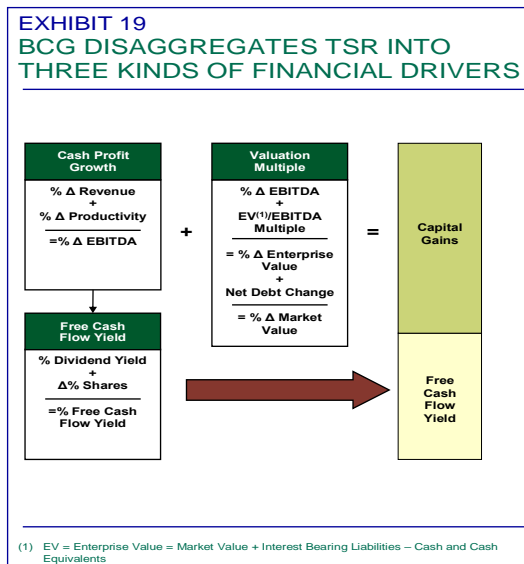
Instead, BCG uses a 'double fade' methodology that is founded on the notion that, over time, the profitability and growth rates of companies fade towards long-run industry averages. The concept of fade is empirically supported and is consistent with the workings of an efficient competitive market in which outperformance is competed away by rivals and underperformance is forced up by capital market pressures.

What is the 'Expectation Premium'?

The Expectation Premium is the difference between market capitalisation and fundamental value. It gets its name from the fact that a difference between these two values implies the market has a different expectation regarding profitability and/or growth fade rates compared to the estimated base case intrinsic value.

What is the 'outside-in' approach?

In the 2004 edition of the global Value Creators Report, BCG introduced a new 'outside-in', or market-based, framework to help understand the dynamics of shareholder value creation. This framework is shown in Exhibit 19. This TSR decomposition framework recognises that, in addition to measures of internal value creation such as CVA, it is important to understand how the market is valuing what a company is doing.



How are Financial Services companies dealt with in the analysis?

Due to the unique accounting framework used for financial services companies (i.e., from the Banks and Insurance sectors), we treat financial services companies slightly differently to non-financial services companies. For financial services companies we make the following adjustments:

Common Book Equity (i.e., Book Equity excluding Preference Equity and Other Outside Equity Interests) and Cash Flow Return on Equity are used instead of Gross Investment and CFROI.

EBITDA is not a useful measure for financial services companies, therefore in our outside-in TSR Decomposition framework, revenue growth is income growth, margin change is the change in the net profit after tax (NPAT) to total income ratio and the change in the multiple is the change in the Equity Value to NPAT multiple (i.e., the P/E multiple). Furthermore, Enterprise Value equals Equity Value, and therefore there is no Net Debt Change factor for financial services companies.

Please note BCG's 2006 edition of the global Value Creators Report (*'Spotlight On Growth: The Role of Growth in Achieving Superior Value Creation'*) excludes financial services companies, as a large number of adjustments would be required given the larger global sample. In Australia, we felt it was important to include them because of the relative significance of financial services in the Australian economy and the smaller number of companies analysed.

What sample was used in the analysis?

Our analysis is based on companies with a market capitalisation greater than A\$1.2b as at 31st December 2006 for whom five-year returns are available (i.e., companies who were listed as at 31st December 2001). Excluded companies include (in alphabetical order): Babcock & Brown, Babcock & Brown Infrastructure Group, Bluescope Steel, Dyno Nobel, Goodman Fielder Macquarie Airports, Macquarie Communications Infrastructure Group, Mayne Pharma, Multiplex Group, Promina, Rinker Group, Sigma Pharmaceuticals, Tattersall's WorleyParsons, and Zinifex.

Five-Year TSRs and Market Capitalisation of Our Sample

Name	Industry	Market Cap as at 31 Dec 2006 (A\$b)	5 Year TSR: 2001-2006 (%)
BHP Billiton	Resources	94.4	23.2
National Australia Bank	Banks	58.6	10.2
Commonwealth Bank	Banks	58.4	16.6
ANZ Banking Group	Banks	48.9	15.9
Telstra	Telco/Utilities	48.2	0.1
Westpac Banking	Banks	42.9	14.1
Rio Tinto	Resources	34.3	17.8
Westfield Group	Real Estate/Infrastructure	31.5	7.6
Woodside Petroleum	Resources	27.8	26.6
Woolworths	Retail	23.1	20.0
QBE Insurance Group	Insurance	18.1	35.1
AMP	Insurance	16.7	-1.3
Macquarie Bank	Diversified Financials	16.3	19.7
St George Bank	Banks	16.0	17.6
Coles Group	Retail	14.6	14.7
Wesfarmers	Industrials/Materials	13.4	8.6
Publishing and Broadcasting Ltd	Media/Entertainment	12.3	20.1
Fosters Group	Consumer	11.8	11.4
Brambles Industries	Industrials/Materials	11.7	7.4
Suncorp-Metway	Diversified Financials	11.3	13.7
AXA Asia Pacific	Insurance	10.7	24.9
CSL	Healthcare	9.6	6.4
Stockland	Real Estate/Infrastructure	9.6	21.3
Macquarie Goodman Group	Real Estate/Infrastructure	9.2	49.4
GPT Group	Real Estate/Infrastructure	9.0	21.5
Insurance Australia Group	Insurance	8.8	20.8
Macquarie Infrastructure Group	Real Estate/Infrastructure	8.5	5.8
Tabcorp Holdings	Media/Entertainment	8.2	17.7
Telecom New Zealand	Telco/Utilities	8.1	12.0
AGL Energy	Telco/Utilities	8.0	25.9
Alumina	Resources	7.9	7.2
Qantas Airways	Transport	7.4	13.1
Newcrest Mining	Resources	7.4	45.5
Toll Holdings	Transport	7.4	23.4
Orica	Industrials/Materials	7.1	32.8
Santos	Resources	6.8	14.7
Amcor	Industrials/Materials	6.3	4.7
Aristocrat Leisure	Media/Entertainment	6.2	22.5
Lend Lease	Real Estate/Infrastructure	6.0	10.6
Centro Property Group	Real Estate/Infrastructure	5.9	29.2
Transurban Group	Transport	5.8	18.8
Origin Energy	Telco/Utilities	5.7	27.3
Caltex Australia	Telco/Utilities	5.7	76.9
Coca-Cola Amatil	Consumer	5.3	9.0
Leighton Holdings	Industrials/Materials	5.2	18.9
Boral	Industrials/Materials	4.8	22.8

Name	Industry	Market Cap as at 31 Dec 2006 (A\$b)	5 Year TSR: 2001-2006 (%)
Computershare	Other ²¹	4.6	12.8
Australian Stock Exchange	Diversified Financials	4.4	33.5
DB RREEF Trust	Real Estate/Infrastructure	4.3	16.5
Lion Nathan	Consumer	4.3	16.7
Oil Search	Resources	4.2	25.2
Sonic Healthcare	Healthcare	4.1	17.0
CFS Gandel Retail Trust	Real Estate/Infrastructure	4.1	17.5
Mirvac Group	Real Estate/Infrastructure	4.1	15.2
Fairfax Media	Media/Entertainment	4.1	9.0
Resmed	Healthcare	4.0	3.9
Oxiana	Resources	3.9	71.3
Harvey Norman Holdings	Retail	3.8	0.9
James Hardie Industries	Industrials/Materials	3.8	13.1
Lihir Gold	Resources	3.6	21.8
Investa Property Group	Real Estate/Infrastructure	3.4	11.9
Alinta	Telco/Utilities	3.4	35.1
Metcash	Retail	3.3	31.9
CSR	Industrials/Materials	3.2	21.5
Billabong International	Consumer	3.1	19.2
Perpetual	Diversified Financials	2.9	19.0
Cochlear	Healthcare	2.9	7.3
Macquarie Office Trust	Real Estate/Infrastructure	2.8	12.5
Allco Finance Group	Diversified Financials	2.6	51.7
ABC Learning Centres	Consumer	2.6	29.0
Macquarie Countrywide	Real Estate/Infrastructure	2.4	15.1
APN News & Media	Media/Entertainment	2.4	17.1
Onesteel	Industrials/Materials	2.3	39.8
Downer EDI	Industrials/Materials	2.2	22.4
Commonwealth Property Office Trust	Real Estate/Infrastructure	2.2	12.1
Sims Group	Industrials/Materials	2.2	35.7
Paladin Resources	Resources	2.2	229.3
Symbion Health	Healthcare	2.1	3.3
ING Industrial Fund	Real Estate/Infrastructure	2.0	15.0
Challenger Financial Services	Diversified Financials	1.9	16.4
West Australia Newspaper	Media/Entertainment	1.9	24.4
United Group	Industrials/Materials	1.8	46.1
Iluka Resources	Resources	1.7	13.0
Ansell	Healthcare	1.6	18.7
ING Office Fund	Real Estate/Infrastructure	1.6	13.6
Paperlinx	Industrials/Materials	1.6	1.5
Futuris	Industrials/Materials	1.4	6.3
Ten Network	Media/Entertainment	1.2	17.3

²¹ Computershare is part of the Information Technology sector. We have classified it as 'Other' for our analysis as it is the only Information Technology company in our sample.

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Barcelona	Lisbon	São Paulo
Beijing	London	Seoul
Berlin	Los Angeles	Shanghai
Boston	Madrid	Singapore
Brussels	Melbourne	Stockholm
Budapest	Mexico City	Stuttgart
Buenos Aires	Miami	Sydney
Chicago	Milan	Taipei
Cologne	Monterrey	Tokyo
Copenhagen	Moscow	Toronto
Dallas	Mumbai	Vienna
Detroit	Munich	Warsaw
Dubai	Nagoya	Washington
Düsseldorf	New Delhi	Zürich
Frankfurt	New Jersey	
Hamburg	New York	