Value Management

Members Meeting

21st June2018

Today's discussion will focus on value creation over time

Recap of main thesis

- **For those not at previous discussions**
- **And because it would be very useful to have your input on positioning**

Preliminary analysis of value creation of the top 250 firms (by market cap) of 2003

- **To assess the link between following a value management approach and delivering value creation**

We will spend most time discussing how companies manage value over the longer term

- **How can companies deliver value over multiple time periods?**
- **How often is a change in approach (strategy) needed?**

If time, a look at buy-backs

- **Used by several value creating companies, but controversial**

Agenda

Recap

Value creation of 2003 firms

Managing value over time

- **Lloyds Bank Group**
- **Imperial**

The allocation of capital

- **Share repurchases**

Why managing intrinsic value is important

CEOs, senior executives and boards of public companies have a dual responsibility

- **To manage the firms they run**
- **To manage the value of which they are temporary custodians**

There is a very wide range of performance in managing value

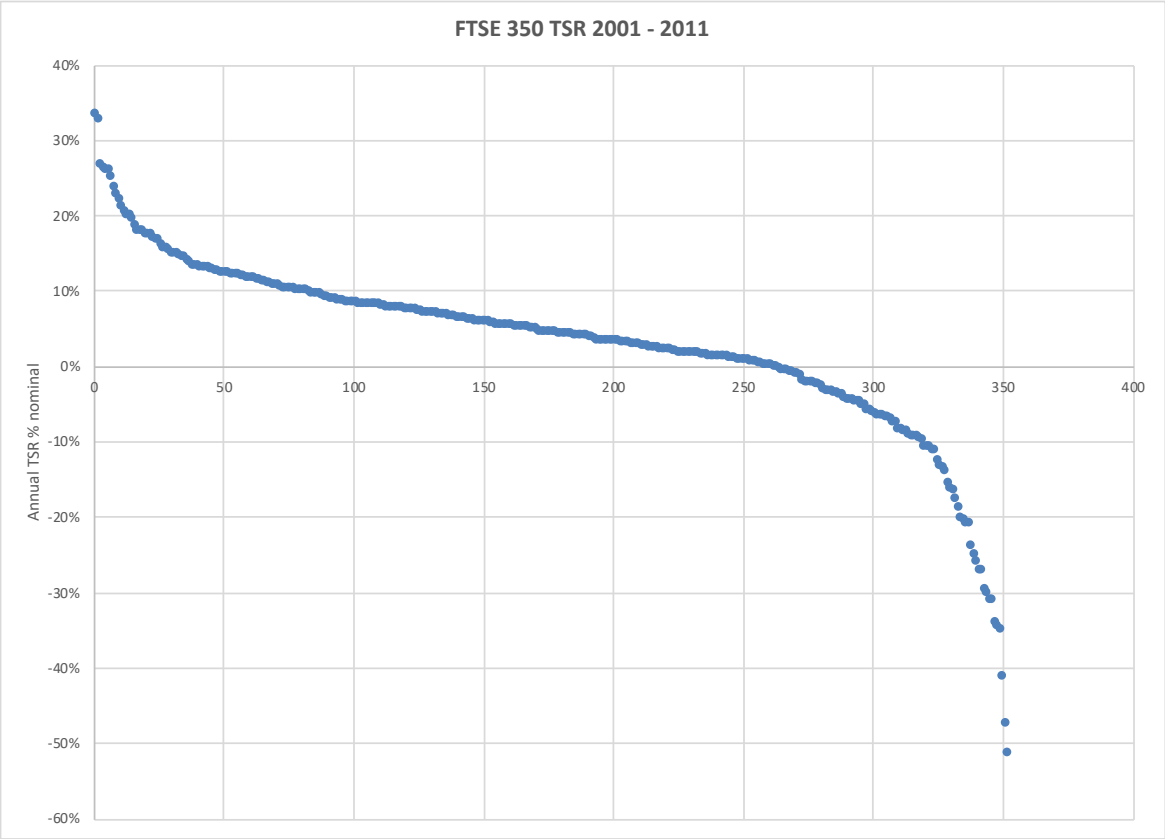
- **About a quarter of the FTSE 350* destroy value (in nominal terms)**
  - **Better to hold bank notes under your mattress than to hold their shares**
- **About 40% earn below inflation rate**

This result of this value destruction is to reduce the value of pensions, life assurance, savings and insurance returns

- **Getting negative TSR companies to zero would have increased annual return from whole FTSE 350 over this decade by c.1% pa (vs c 5% long term equity returns)**
- **Getting all companies > inflation rate would have added c. 1.5%pa**

* 10 year period 2001 – 11, About 20% of top 250 companies worse than cash 2004 - 16

Spread of TSR performance for FTSE 350



Average TSR =
5.5% pa (mean)
7.3% p.a. (median)

To be top quartile required 9.1% pa
(with average TQ TSR = 15%)

All constituents in the bottom quartile earnt < 0% pa
(with average BQ TSR of -11.5%)

Average inflation 3.1%
140 companies TSR below this

Source: Datastream

NB over the last 110 years equities have returned about 5% real in the US and the UK

Firm level value creation drives economic progress

The direct effect of increasing the level of intrinsic value creation is to increase national/corporate wealth

- **But the more interesting observation is what causes the increased value**

Greater intrinsic value creation results from improved returns on existing assets and optimal allocation of resources to new opportunities

- **Whilst shrinking assets and activities where returns poor**
- **And higher (comparative) returns provide surpluses for greater investment and growth**

Inadequate value creation is indicative of poor operational improvements, poor strategy and poor asset allocation

With the well discussed caveat that we are talking about genuine creation of intrinsic value (the hypothetical NPV of the DCF of a business)

- **Not fiddling with short term accounting numbers etc**

What would increase the delivery of intrinsic value creation?

There are some excellent value managers out there, but not that many

- **Creating very high returns and their companies (and to themselves)**
- **But the issue is one of scarcity**
  - **The average CEO, senior executive and board member is (IMHO) not very skilled at this critical task**
  - **There are nowhere near enough excellent executives to fill available roles**
    - **General management capability appears to have greatly improved**
    - **But the ability to create and drive value creating strategies appears to have stagnated or even diminished**

How can this problem of scarcity be addressed?

- **Minds: educate existing and future leaders about managing value**
- **Hearts: illustrate the massive contribution made by better value managers, and address the false narrative that some have about genuine value creation**

Complacency and unwillingness to learn?

Given that any public company CEO must see their job (at least in part) as creating value, there is widespread ignorance about how to do this

- **How many are really familiar with the approach of Buffett at Berkshire Hathaway, or Habgood at Bunzl, Whitbread and Relx, or Wolfson at Next, or Swann at WH Smith, or Welch at GE, or Davis at Imperial Tobacco, or Becht at Reckitt, or Pitman at Lloyds, etc etc**

In other competitive spheres (military, sports etc) there is much greater structured learning about winners and winning approaches

- **Perhaps greater willingness to overcome the normal resistance to learn?**
- **Perhaps greater (personal) cost to failure?**

Are the structural and incentive blocks to increasing focus on value creation

- **Is delta between personal rewards for value creation and value destruction optimal for executives? Is the weighting between truly variable and 'fixed' reward sufficient?**
- **Are all participants weighing value creation adequately? E.g., are NEDs structurally more (personal reputation) risk adverse than they are (corporate) value seeking?**

This project is trying to offer learnings on being an effective value creator

Focus is on managers of large commercial businesses

- **Managers who do not own the company**
- **But see their role as creating intrinsic value over their tenure**

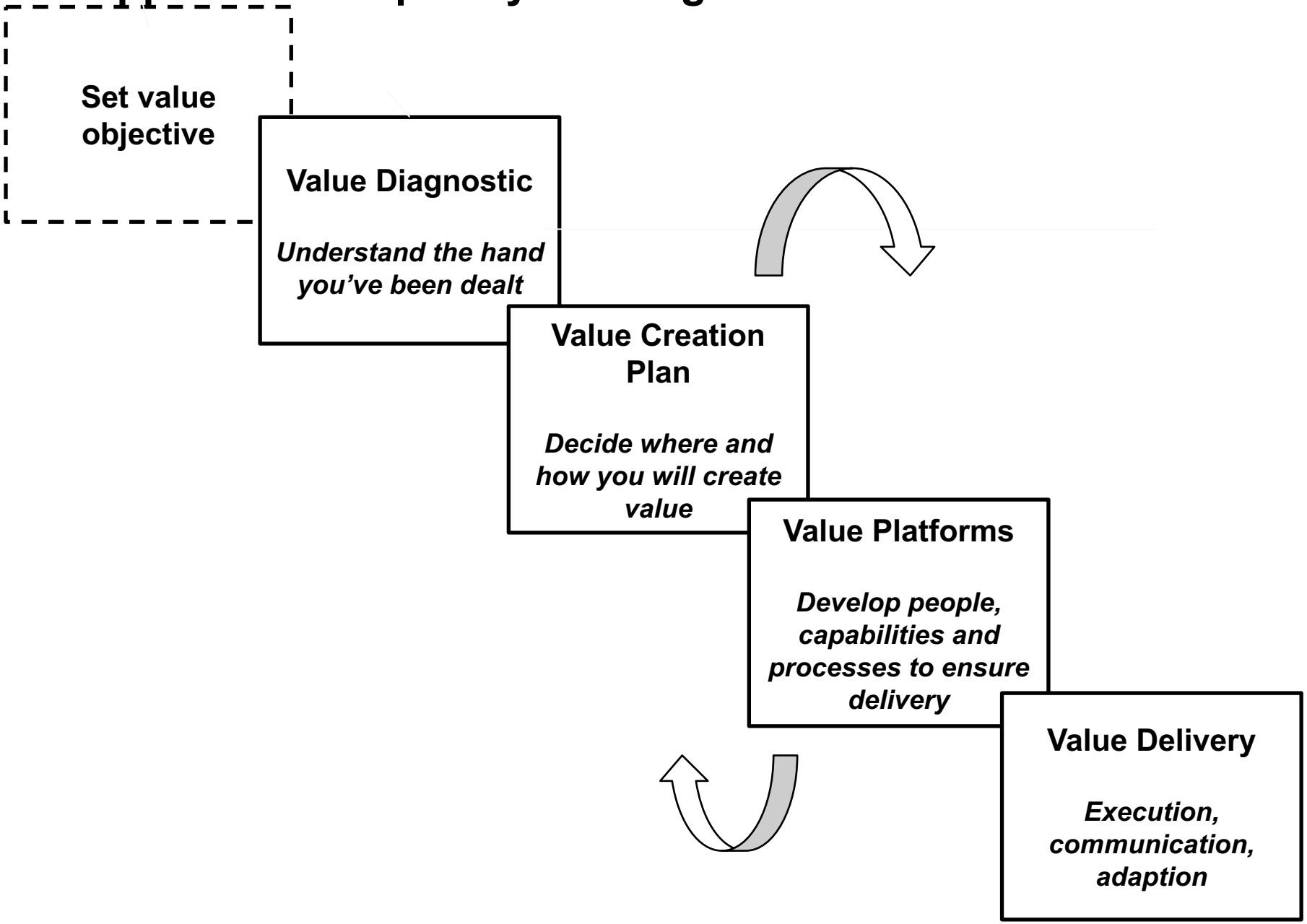
The research primarily uses detailed case studies with some supporting quantitative analysis

- **Whilst there is much consistency about goal (long term intrinsic value creation), companies have unique (and complicated) situations**
- **Strategies and tools are therefore situational**
- **People (with all their foibles) are central to the stories**
- **Any company has thousand of attributes and so simplistic descriptions or simplistic causality does not properly reflect the task of a value manager**

The work is as much social science as maths

- **The maths of value management is not that complicated**
- **Adopting it is perhaps an issue of philosophy, psychology and temperament**
- **Deploying it in a large, complex organization requires leadership, energy, discipline, operational and organizational effectiveness**

An approach to explicitly creating value: The holistic value manager



Discussion for RG

Do you agree that the CEO has this dual function of managing the business and managing the value of the company?

Do you agree that the average CEO has significant capability gaps in managing value?

Why do you think that is, and (if so) what could be done to address it?

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I am working through a value creation data-set

I have taken the 250 largest market cap companies as at December 2003

- **After excluding Investment Trusts and a couple of funnies**
- **And then tracked their TSR by month till 2015 (currently Sept but will be Dec)**

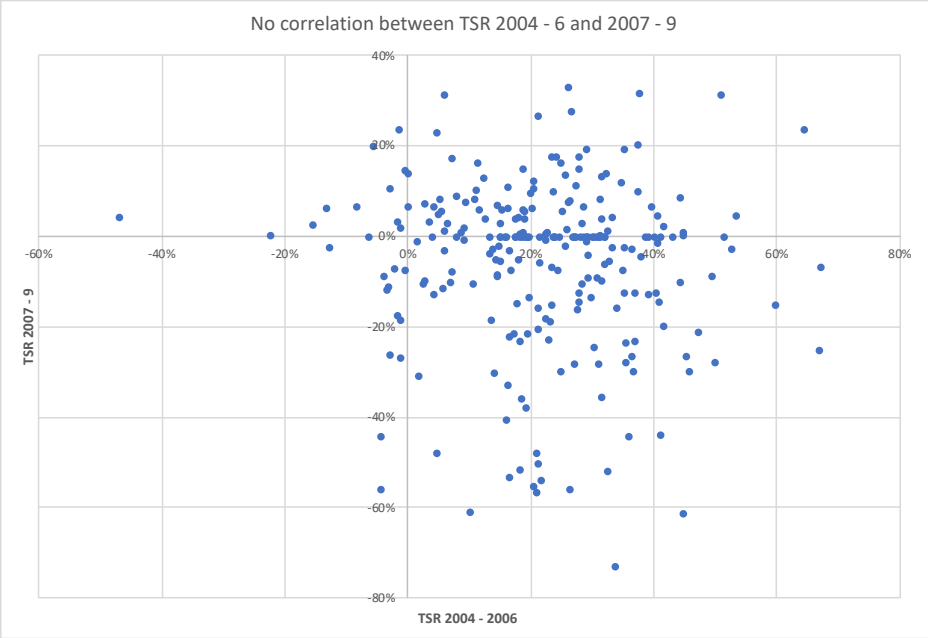
One objective is to contrast the outcomes for higher & lower value performers over 12 years

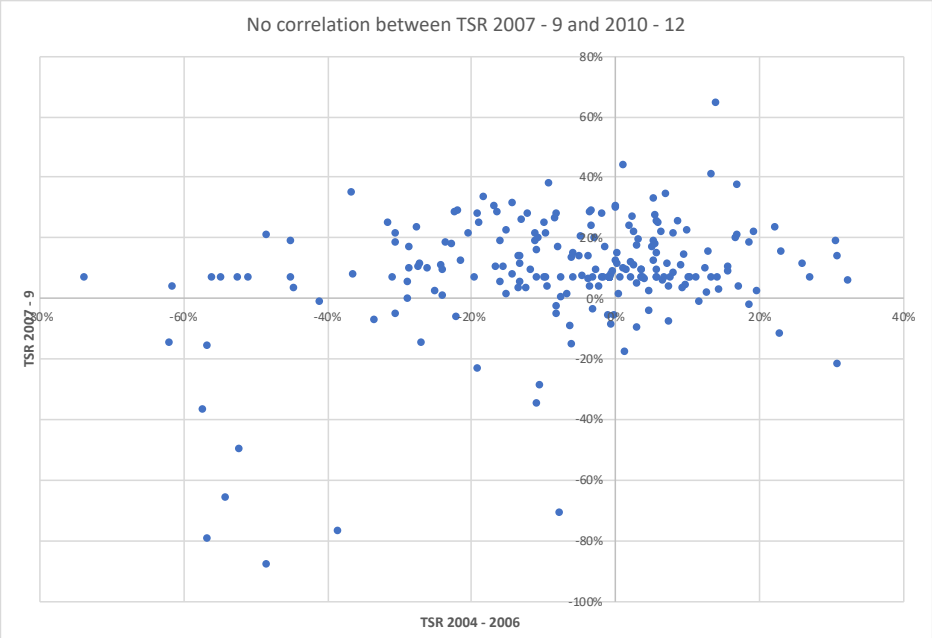
- **Top quintile turned £1 into £6.60, bottom quintile into 55p (average for all £3)**
- **159 companies survived, 91 no longer exist/independent**
  - **7 takeovers on top quintile**
  - **17 takeovers, 5 bankruptcies in bottom quintile**

The other objective is to assess the correlation between value practices and value outcome

- **Value performance appears independent of size, growth etc**
- **It seems mostly independent of sector – although banks weaker, and utilities broadly stronger ex-post for this period**
- **Subsequent TSR performance not correlated with previous TSR performance**

An important observation is that TSR does not have persistence





This is not unexpected

- **Efficient markets (on average)**

But it has an important managerial implication

- **TSR is a "clean slate" – over-performance is required over many periods**
  - **Suggests a <u>multi-period</u> value creating plan is ideal, if difficult**
- **Size, growth, profitability etc are highly persistent measures and are not a good measure of managerial performance**

Long term out-performers tend to be serial out-performers

The 12 year period can be split into four 3-year periods

- **And we can examine over- and under-performance within each part**

Top quintile performers over the 12 years had two characteristics:

- **Consistency: More frequent appearances in 3-year top quintile groups**
  - **Number of 3 year top quintile performances for**
  - **TQ 1 appearance = 20 companies, 2 = 22, 3 = 8, 4 = 0**
  - **BQ 1 = 10, 2 = 0, 3 = 0, 4 = 0**
- **No shocks: Number of companies <(20)% pa TSR for a 3 year period**
  - **TQ = 3 (out of 50 companies, and only one period)**
  - **BQ = 31 companies (some several periods)**

Not surprisingly being a long term value creator requires repeated good performance and avoiding value collapses

- **Lessons for managing long term value**
  - **Need to manage the medium (3 year?) value plan**
  - **AND to repeat that over multiple-periods**
  - **AND avoid major risks to value**

I am testing whether best value creators have taken a value approach

Company	£100 invested in 2004		Key CEO/ Exec	Value managed?	Notes
Smith WH plc	1137		Swann	Yes	
Amlin plc	1028			?	Acquisition
London Stock Exchange Group	1025		Rolet	Yes	
Next plc	997		Wolfson	Yes	
DCC plc	911				Dublin based
Shire plc	876		Russell	Yes	
Whitbread plc	853		Habgood	Yes	
SABMiller	842				
Henderson Group plc	830				
ARM Holdings plc	827		East	Yes	Softbank
British American Tobacco	785		Adams	Yes	
International Power plc	772				
Northumbrian Water Group plc	766				
Provident Financial plc	743				
Berkeley Group Holdings plc	741				
Associated British Foods	735		Weston	Yes	
Halma plc	702		Williams	Yes	
St James's Place plc	685				
easyJet plc	673				
Reckitt Benckiser Group plc	671		Becht	Yes	
Intertek Group	641				
Capita plc	634				
Weir Group plc	620				
Kingspan Group plc	618				
Smith (DS) plc	614				
Schroders plc	606				
Stagecoach Group plc	595				
Intercontinental Hotels Gp	593				
Thomson Reuters plc	579				
Imperial Tobacco Group plc	573		Davis	Yes	becoming less VM?
Bunzl plc	563		Habgood	Yes	

Preliminary

I am using the framework previously discussed to assess value focus

Managerial Focus	Goal Focus	Value Focus
• Wide range of objectives	• Handful of key goals	• Unambiguous objective of value creation
• Objectives a mix of ends and means	• Levers support key goals	• Neutral on levers of value
• Balanced business scorecard	• Clear link levers to goals; unclear how to trade-off between goals	• Clear articulation of how levers drive value creation
• Capex used to build all businesses	• Capex skewed to key goals	• Capex skewed to high return opportunities
• Most capital retained	• Capex vs returning cash driven by business needs	• Capex vs returning cash driven by prospective ROCE
• Radical strategies rarely examined	• Business strategy driven by goals	• Business strategy driven by value
• Tendency to empire build	• Portfolio optimised to meet corporate goals	• Corporate shape driven by businesses value creation
• Targets set by bottom up budgets	• Targets set by bottom up budget and top down strategic goals	• Targets set by value creation goals, inc dividend & capital gain
• Budget process primary	• Budget process shaped by strategy process	• All management processes aligned around value creation
• Risk register mostly operational	• Risk register operational + strategic	• Risk register operational + strategic + to value
• Prefer internally measured incentives	• Mix of incentives	• Value creation drives incentive structure

And whether value destroyers have not

£1 invested 2004 worth less than a £1 now (dividends reinvested, nominal)

Tesco plc
Northern Foods
First Calgary Petroleums
Cable & Wireless Worldwide
Carpetright plc
Serco Group plc
Premier Farnell plc
Barclays plc
Ladbrokes plc
Logica plc
Avis Europe plc
FirstGroup plc
Alliance & Leicester plc
Colt Group S.A.
Darty plc
Dixons Retail plc
Groupe Eurotunnel SA
Anglo American plc
Enterprise Inns plc
Lloyds Banking Group plc
Trinity Mirror plc
Brixton plc
Bradford & Bingley plc
iSOFT Group plc

Wipe-outs

Northern Rock plc
HBOS plc
Woolworths Group
Royal Bank of Scotland Group
Punch Taverns plc
Bank of Ireland
Anglo Irish Bank
Allied Irish Banks plc'Ord'
Lonmin
Independent News & Media plc
HMV Group plc
Johnston Press plc
Irish Life & Permanent Group
hibu plc
JJB Sports plc

Emerging themes

Huge difference in value performance between best and worst

Efficient markets mean no obvious starting position associated with subsequent shareholder returns. Fascinating pairs:

- **Tesco's with all its advantages in 2003/4 massively underperformed WH Smith**
- **BAT in the declining cigarette market had same value creation as ARM – a hugely successful chip manufacturer in a booming market**
- **An investment in Reckitt Benckiser returned double an investment in Unilever**

Top performance comes from frequent out-performance and avoid negative shocks

- **Noting that a couple were acquired at a good price**
- **And perhaps a tailwind for higher yield utilities in this period of a zero interest rate world (and a headwind for banks)**

Frequent out-performance does appear to be linked with adopting many of the lessons we have discussed under this research topic

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The importance of time

Time provides the beat

- **Value creation is a quantum of change in a period of time**
- **Future out-performance is not correlated with past out-performance**
- **A value creating strategy is time limited and needs renewal**
  - **Often more (and enough) of the same**
  - **Occasionally a fundamental shift**

We can draw on 2 new examples to explore these themes

- **Lloyds under Pitman created great value for a decade, but this was not repeated**
  - **Lloyds was an early adopter and so useful to illustrate how the application of value management evolved over time**
  - **And the dangers of not developing a long term value strategy alongside the medium term one**
- **Imperial Tobacco has created great value since 2000**
  - **Example of creating value in a declining industry**
  - **Long term history of the industry shows the need to shift strategies every couple of decades**

Learnings from Lloyds

Brian Pitman and Lloyds Bank were early adopters of value management in the early 1980s

- **Good to add a bank to the data set, and not many financial institutions have been value focussed**
- **Helpful to assess how an early adopter evolved their approach over time**
- **Value focus greatly watered down after HBOS merger (2008)**

The 35 year history and the turbulent banking crises highlight the critical link between (value-based) strategy and value creation

- **The longevity of a specific strategy can vary**
  - **Knowing when to revisit/change a strategy is important**
  - **The context can change**
- **The balance between short term and long term goals and trade-offs can vary**

Brian Pitman and Lloyds Bank

Lloyds Bank was established in Birmingham in 1765 and grew rapidly in the early 20th century

- **Organic growth and acquisitions created UK-wide network pre-WW2**
- **Acquisitions in Argentina (1918) and Brazil (1923) started the international scope of the bank**
- **By 1984 branches in 47 countries in Europe, South America, North America, Australia, NZ, Far East etc accounted for about half of assets and profits**

Early 1980s posed a number of challenges to the bank

- **Weak global economy, South American debt crisis, deregulation**
- **In this environment, assets grew from £20B (1980) to £35B (1982)**
- **With profits up somewhat before provisions, but heavily down after provisions**

Pitman and Morse were an interesting partnership

Sir Jeremy Morse was not your typical retail banker

- Norfolk brewing family; Winchester; Oxford where he won 5 of the 7 major classics prizes; elected Fellow of All Souls in 1953
- "Cadet" at Glyn, Mills bank, becoming a director in 1964
- 1965 Executive Director Bank of England, worked at IMF
- 1975 joined Lloyds board as Deputy Chair, 1977 Chair (aged 47)
- International chess judge, poet, cryptic crossword author, devout Christian

Sir Brian Pitman had 30 years of banking experience when he became CEO

- Raised by his mother when father died when he was 9 weeks old
  - Taught him "it's not money that matters in life"
- Won scholarship to Cheltenham GS, didn't go to university
- Joined Lloyds Cheltenham branch in 1952
- Lent to Slater/Goldsmith etc in early 1970s, and then worked with BoE to save banking sector after 1973 property crash and 1974 stock market crash
- Head of Lloyds Bank Intl in late 1970s, before 1980s S. American defaults
- Interestingly Chairman Next 1998 – 2002
- Loved cricket and music

Pitman, Morse and the board had broad discussion on goals

On appointment Pitman led a board discussion to agree "what constituted success for Lloyds"

- He wanted to create "a single, well defined performance measure" to "replace our existing array of implicit objectives: serve shareholders, serve customers, serve employees, serve society in general. Such woolly goals get you nowhere because they aren't specific enough to have an effect on people's performance."
- Quickly agreed wanted to be "best" financial services company – but too vague
- Agreed a "single governing objective of improving shareholder value" with a performance measure of ROE

In 1984 agreed to use ROE vs a cost of capital (and later for bonuses vs peer ROE)

In early 1990s, board felt beating (UK) peer ROE too easy and wanted a stretch goal

- Pitman borrowed goal of doubling share price every 3 years from Coca Cola

There were issues with these goals

Pitman used value goals, measures and targets to drive a remarkable transformation

- **Clear focus and rejection of balanced business scorecard mentality**
- **Effective translation of goals to cascade of relevant and controllable metrics/targets through organisation**
- **But there are issues with his choice of measures and their link with strategy**

Level of ROE is not the same as intrinsic value creation

- **ROE measure translated into two managerial goals: improve ROE and exit businesses that could not earn the CoC**

Doubling share price every 3 years is also not the same as intrinsic value creation

- **Emphasises share price over dividends/ cash returns**
- **Is greatly affected by general market movements**
- **Implies 26% TSR p.a. (+ dividends) which drives rapid value creation**

Did these measures/targets adversely impact strategy?

- **Did ROE approach (as opposed to TSR) overemphasise level of ROE (vs change) and de-emphasise cash generation?**
- **Did stretch over-emphasis short term (3 year?) strategies over longer term ones?**

Between 1983 and 1986 Pitman changed his strategy

CEO Report March 1984

Over the past decade or so, we have pursued a policy of broadening the base of our activities, both geographically and by range of services, to become a major international bank. This diversification has two important implications: first, it positions us to take advantage of opportunities whenever or wherever they occur; and, second, it enables us to obtain a wide spread of risk.

Although the 1983 level of provisions does not please us, our ability to absorb them is evidence of the strength of our broad earnings base.

While we seek to offer a wide range of services, it is unrealistic to believe that we can be the best in every financial product and in every financial market.

Concentration on areas of profitable growth, where we have, or can acquire, competitive advantages to succeed, remains at the core of our strategy. This strategy demands that we continuously review the many activities we are in, modify some and expand others to remain responsive to ever-evolving markets.

CEO Report February 1986

For more than a quarter of a century, most of the world's major banks have been growth companies — growing substantially in terms of customers, products, global reach, assets, revenues and costs.

Until recently, this has been a successful policy, but over the past few years the link between growth and profits has weakened.

By itself, growth does not benefit our shareholders. They will gain only if Lloyds Bank consistently produces an attractive return on equity, from which share price increases and higher dividends flow.

Our policy is to concentrate our resources on those markets where we can be among the leaders, which in some cases means leadership in a particular segment of the market, and to avoid those activities where realistically we cannot obtain a strong position.

Actions: Scale advantaged UK bank-assurance

1980 | 1985 | 1990 | 1995 | 2000 | 2005 | 2010 | 2015 | 2020

Geographic markets

- 1986 bid for Standard Chartered
- 19xx sold [overseas]
- 2003 sold NZ
- 2003 sold Brazil

Product markets

- 1985 Big Bang did not buy broker
- 1988 bought Abbey Life "bankassurance"
- 1999 bought Scottish Widows

Relative UK scale

- 1992 bid for Midlands Bank
- 1994 bought Cheltenham & Gloucester
- 1995 bought TSB
- 2002 not allowed to buy Abbey National
- 2002 CC rule out mergers between big 4
- 2007 looked at buying Northern Rock
- 2008 Merger with HBOS
- 2013 Forced sale of some branches

- 1985 Lloyds and LB Intl merged
- 1992 introduced performance related pay
- 2009 Government take 43% stake

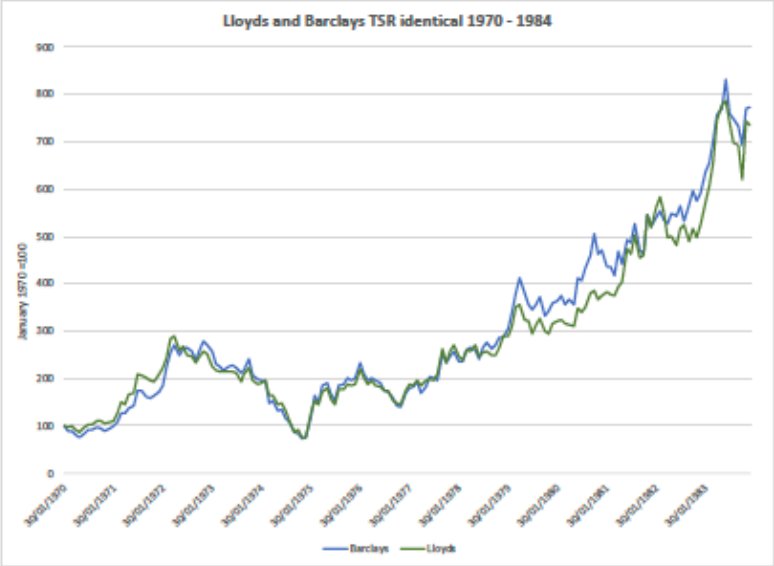
CEO

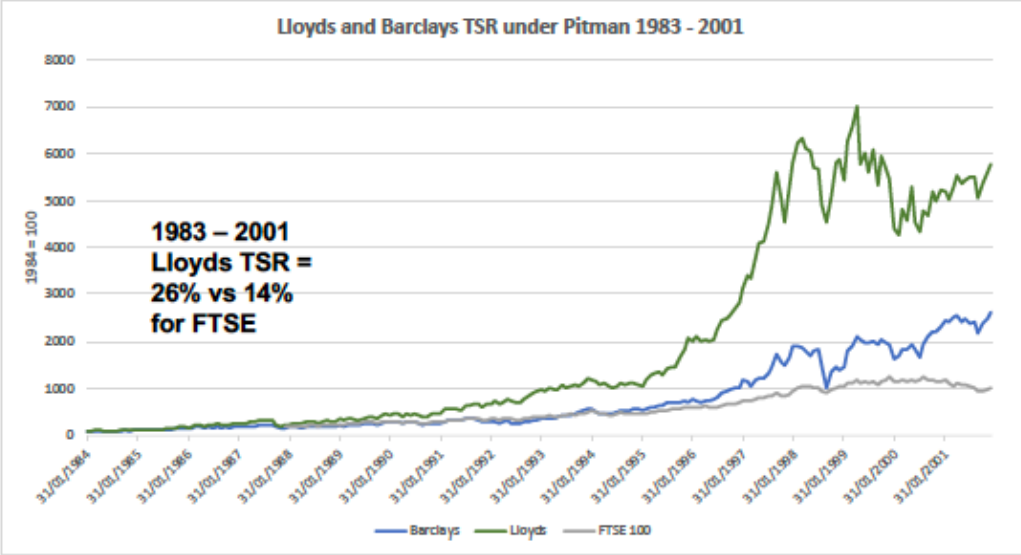
Pitman 1983 - 1996 → Elwood 1996 - 2003 → Daniels 2003 – 2011 → Osorio 2011 –

Chair

Morse 1977 - 1996 → Pitman 1996 - 2001 → V d Bergh 1996 - 2001 → Blank 2006 - 2009 → Biscoff 2009 - 2014 → Blackwell 2014 -

The Pitman years

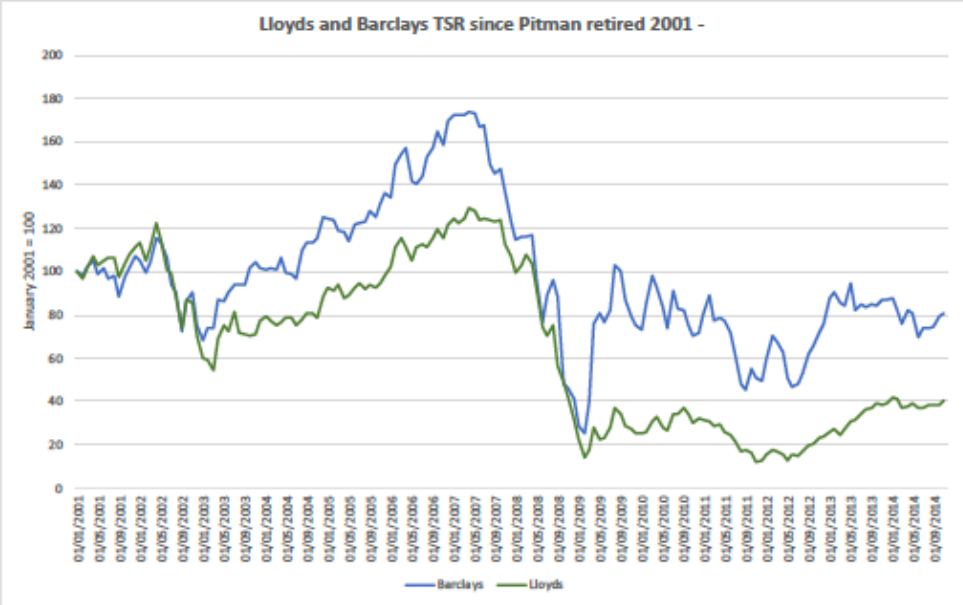




After Pitman retired in 2001, Lloyds under-performed Barclays through to 2007

The 2007 crash hit Barclays even harder than Lloyds

Lloyds then bought HBOS, and became 43% government owned, with disastrous results for TSR



Could Lloyds have developed a 30 year value creating plan?

However imperfect, the Pitman push for value seems to have delivered a considerable growth in TSR (1990 – 2000 in particular)

- **Driven by a strategy of UK consolidation, cost cutting, and exiting poorer return positions**
- **All delivering much increased ROE**

But after Pitman Lloyds lost its way (on value creation)

- **Could not find an executable strategy that it was comfortable with**
  - **Wanted growth in a mature stagnant market in which it could not make acquisitions rather than to just throw off cash**
  - **But did not want to make investments/risk of growth elsewhere**
- **And so got sucked in to the disastrous HBOS acquisition**

Raises interesting question about time horizon, and how strategy and value management interact in complex environments

- **Is there an argument for multi-time horizon value agendas?**
- **How do strategies evolve, especially after a period of great success?**

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Imperial (and BAT) created substantial value since 2000

The sources of value creation in the cigarette industry have evolved over the last century

- **With fundamental shifts required every 20 – 30 years**
- **More modest value strategies work well until there is a discontinuity, at which point a more radical value strategy**

The biggest discontinuity of recent decades is that the industry has been facing expected decline for 50 years

- **Took ~ 20 years to overcome growth bias and adopt value creating strategies**
- **But the greatest value creation has occurred once strategies adapted for this changing environment**

BAT and Imperial are good examples of creating value in a declining industry

- **If cash generation is high enough to provide top quartile returns to shareholders**

The cigarette industry provides a number of lessons

Highlights the role of value drivers changing over strategic eras: maybe 6 in 160 years:

- **Pre-1880s fragmented industry**
- **1881 – 1911 consolidation driven by scale technology**
- **1911 – 1950s growth driven by marketing and cost advantage vs other tobacco**
- **1950s – 1970s Peak cigarette – heavy advertising to create brands, widespread distribution, huge efficiency gains**
- **1970s – 1980s offsetting decline: internationalisation and diversification**
- **1990s – focus and cash generation**

Creating value in the period of decline proved challenging

- **Took ~ 20 years to overcome growth bias**

BAT and Imperial are good examples of creating value in a declining industry

- **If cash generation is high enough to provide top quartile returns to shareholders**

1891 – 1911 strategic era driven by technology

Pre-rolled (by hand) cigarettes developed mid/late 1800s, predominately in US and UK

- **Many small competitors in a relatively small industry**

A new technology, the Bonsack rolling machine (1881), reduced rolling costs by 50%

- **The market leader (Allen & Ginter) chose to stick with hand-rolled production**
- **W Duke used the new technology strategically: moving to 100% mechanized in 1880s; established agreement with Bonsack that gave them an advantaged price for machines; spent heavily on advertising; pushed prices down; accepted lower profits**

Duke's cost advantage enabled them become US market leader and then to consolidate the five leading firms into the American Tobacco Company in 1890

- **With around 90% US market share**
- **Hit by ATC in their export markets, 13 UK competitors amalgamated to form Imperial Tobacco in 1901**
- **In 1902 Imperial and ATC jointly formed British American Tobacco to operate in all non-US, non-UK markets**

In 1907 ATC was indicted for violating the Sherman Antitrust Act and in 1911 was split into four competitors

1914 – 1940s era fast growth driven by substitution

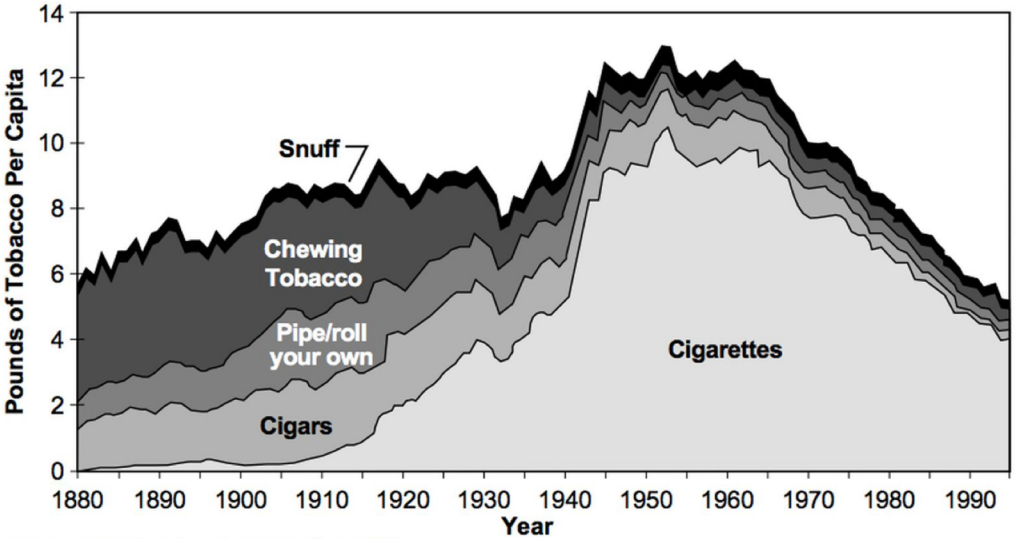
Cigarettes gained share against other forms of tobacco pre-WW2

- Lower costs as rolling machines improved
- Heavy advertising drives consumer preferences
- Rising incomes
- Low duties and taxes
- Big rise as WW2 socialises use of cigarettes

By 1950 substitution largely complete

- With cigarettes ubiquitous

Per capita consumption of different forms of tobacco in the United States, 1880-1995



Source: U.S. Department of Agriculture, 1996.

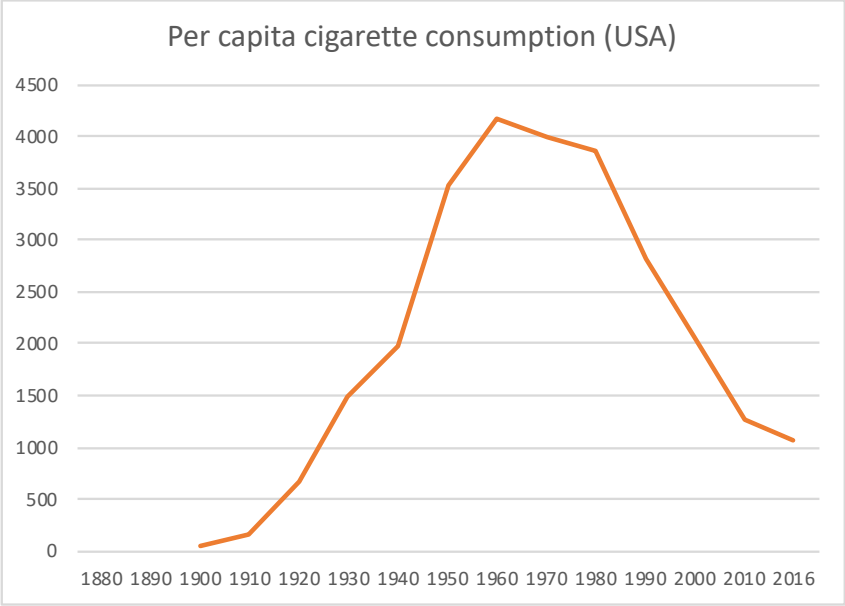
The era since 1960s driven by managing domestic decline

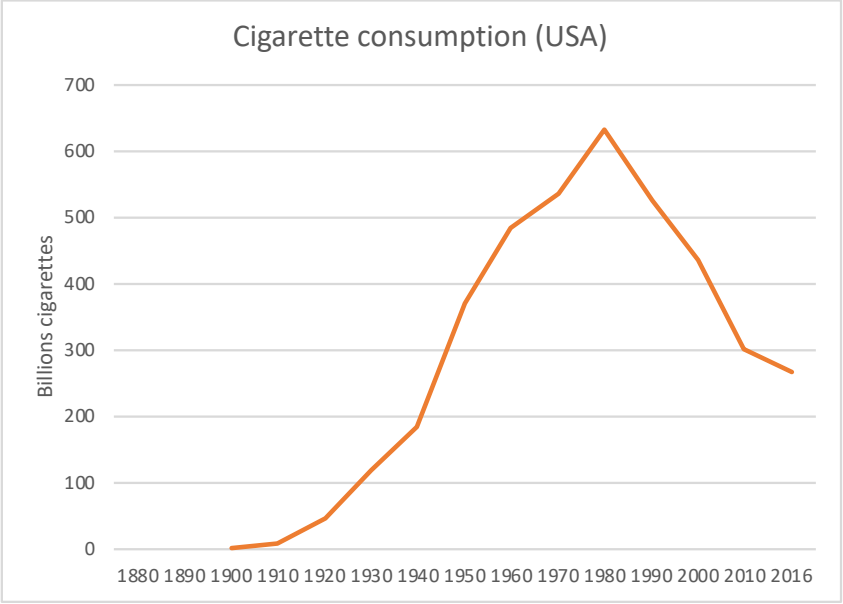
The 1950s saw the emergence of major health concerns with smoking and in 1964 the Surgeon General issued a report linking smoking and lung cancer

- **And the 1984 Surgeon General's report on second-hand smoking**
- **Increasingly strict bans on advertising since 1970s**
- **Price rises from c. $1.50 - .60 (1950s) to $5 – 6 (today) driven by manufacturers raising price and some tax increases (more in Europe)**

Impending decline clear from mature market trends since 1960s

- **Substitution complete, per-capita sales in decline**





Five part response to decline

Exploit shift within market to filters, low tar and menthol

- **And more recently e-cigarettes**

Expand margins

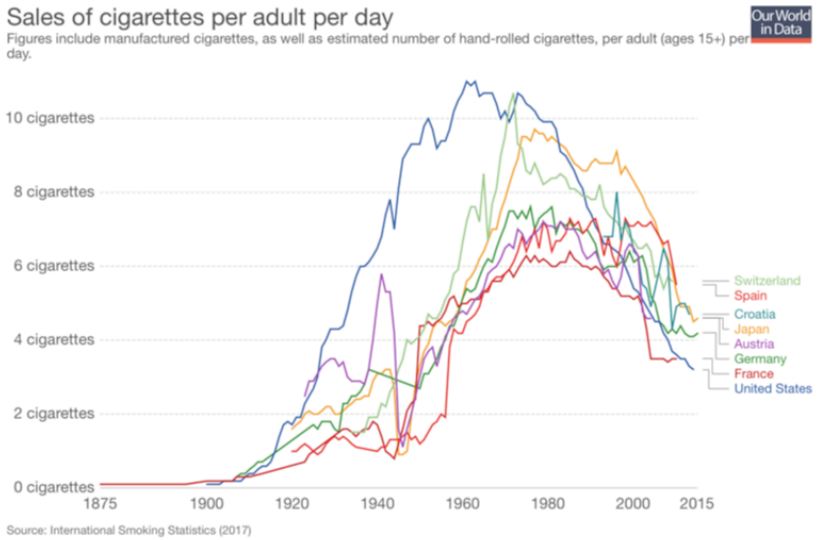
- **Raise prices (ex-duty)**
- **Cut costs: rolling equipment now 10x more efficient than in 1950**

Increase advertising (until c 2005 when regulation limits that strategy)

Focus on international sales

- **Declines starts later**
- **Global sales now in decline**

Use cash flow to diversify



For a while, diversification was seen as a way to address decline

	BAT	Imperial	Philip Morris	Reynolds	Others
1960s	Paper/Pulp Tonibell (ice cream) Lentheric (cosmetics) Yardley Perfume National Oats		Clark's chewing gum Miller Beer	Pacific Hawiian punch Sea Land Service	L&M buys Alpo dog food L buys Golden Nugget L buys Reed Candy AT buys Sunshine biscuits AT buys James Beam
1970s	Kohl stores Saks Fifth Avenue NCR's Paper division Argos	Animal Feed (from ABF)		Del Monte Foods	
1980s	Marshall Fields Eagle Star Allied Dunbar Farmers Group			Nabisco Foods	
Exit	Most retailing sold 1980s, Financial Services 1990s	Bought by Hanson		Bought by KKR 1987 RJ Reynolds spun out 1999	

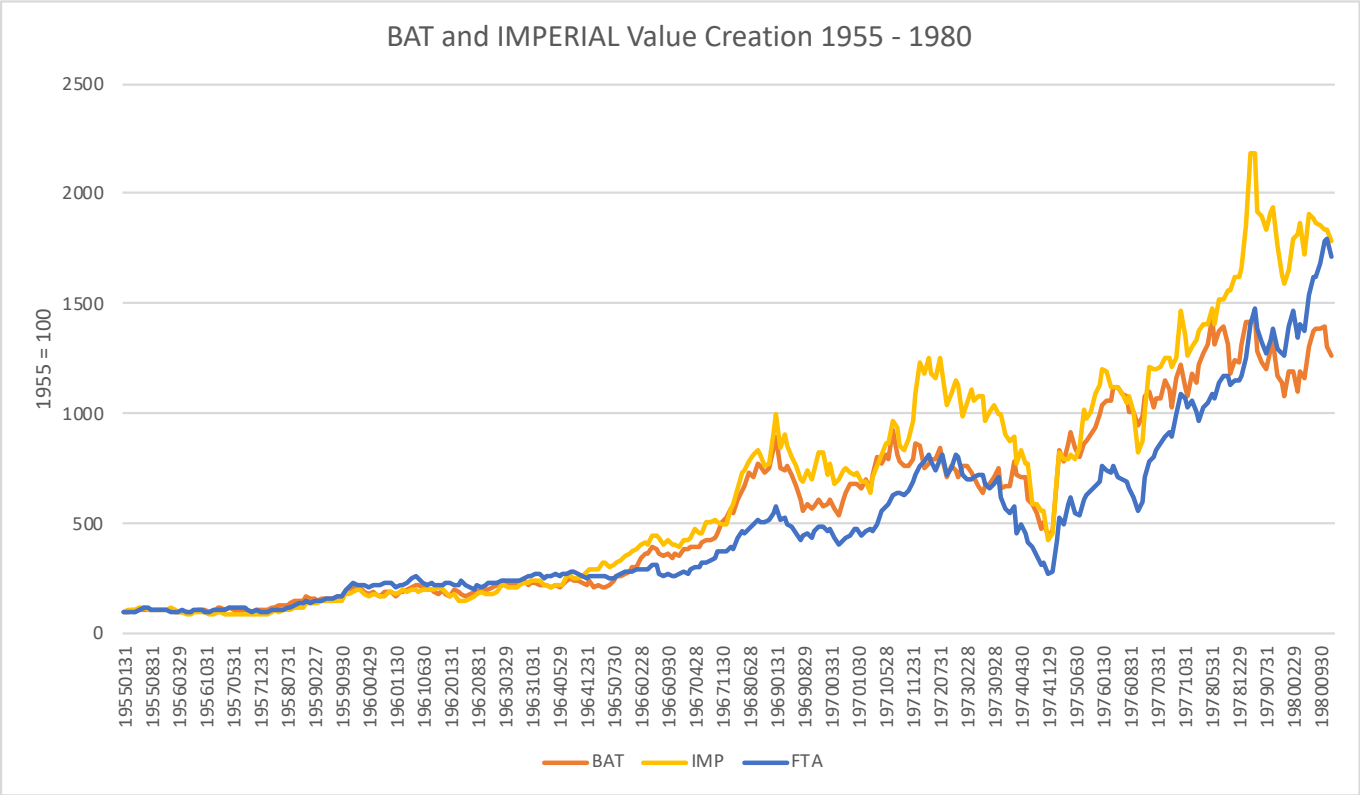
It took nearly 20 years (and Hanson and KKR) for the cigarette manufacturers to see that unrelated diversification was not value creating ….

…. But the siren calls of growth (any growth) are strong

Between 1955 and 1980 BAT and Imperial tracked the market

Over 25 years Total Returns to Shareholders approximately tracked the market (12%)

- **With Imperial perhaps doing somewhat better at 12% (less diversification?)**
- **And BAT delivering 11%**
- **Nominal: inflation 8% pa**



Imperial's new strategy emphasised cash generation

Imperial purchased by Hanson and a new approach implemented

- **Portfolio re-focussed**
- **Efficiency emphasised**
- **Capital restricted**

IPO from Hanson 1996

- **Derek Bonham as Chair and Gareth Davis as CEO (remained CEO until May 2010)**

Strategy driven by value creation

- ***"to create sustainable shareholder value by growing our international operation while continuing to strengthen our market position in the UK."* (2001 AR)**

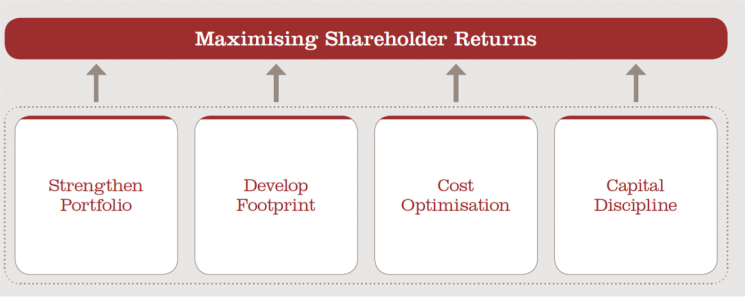
Targets and rewards aligned

- **LTIP with TSR (1996 – 2001) and TSR and real EPS (after 2001)**

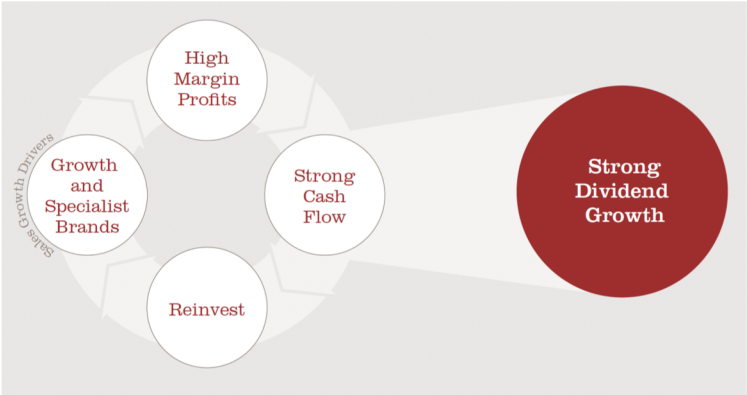
Aggressive dividend growth policy, and buy-backs introduced

Imperial's new strategy clearly differentiated growth and mature markets

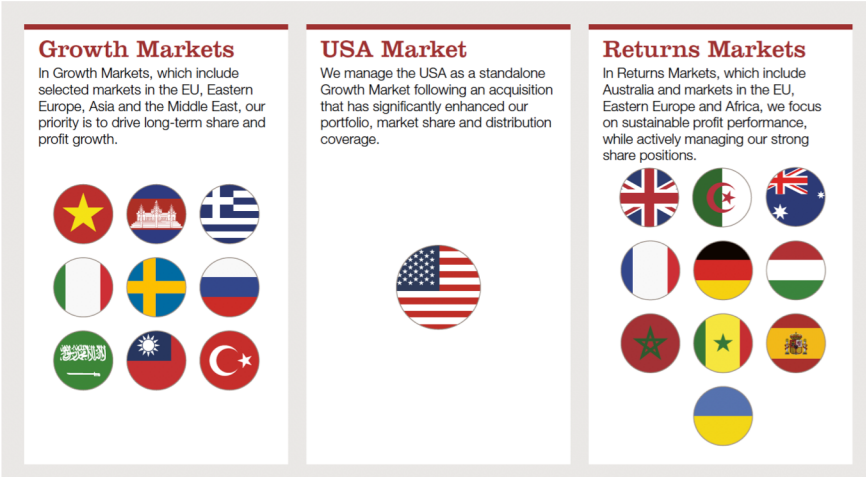
Strategy



Business model



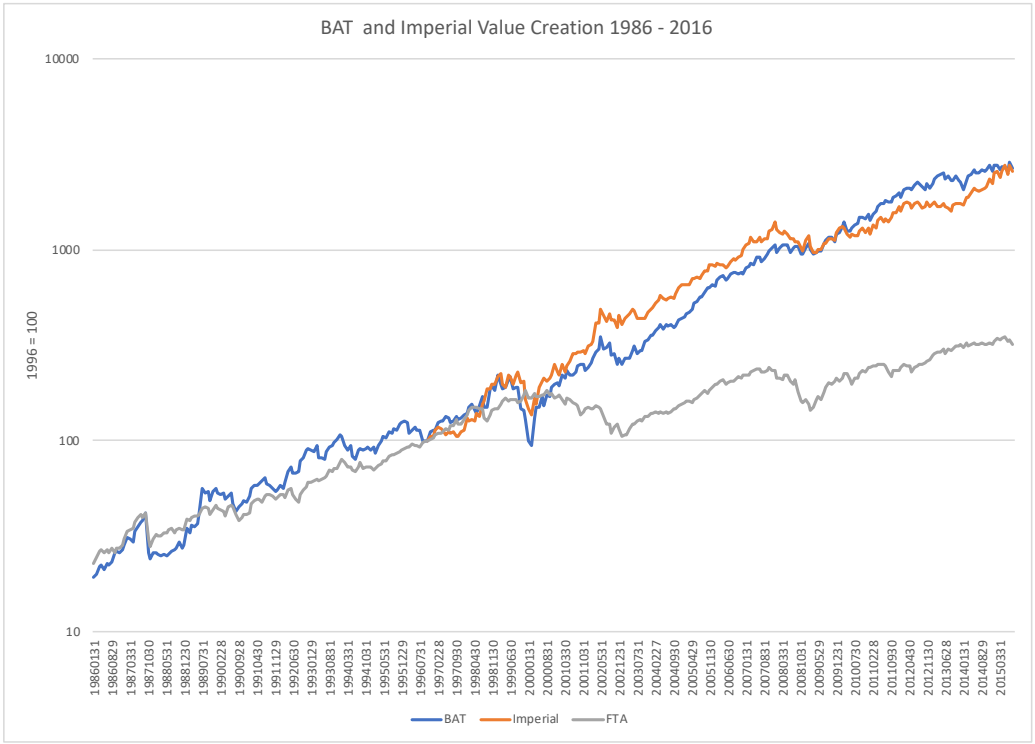
Clarity about growth vs returns



After half a century of tracking the market, Imperial has had two decades of out-performance

Imperial's greatest relative value creation has come as many of its key markets have declined

- **First response strategy of diversification failed to address this**
- **Second iteration of strategy has been a great (value) success**
  - **Price management, cost management, limited capex, (volume) growth only where profitable**
  - **Two big synergistic acquisitions: Altadis, Reemtsma**



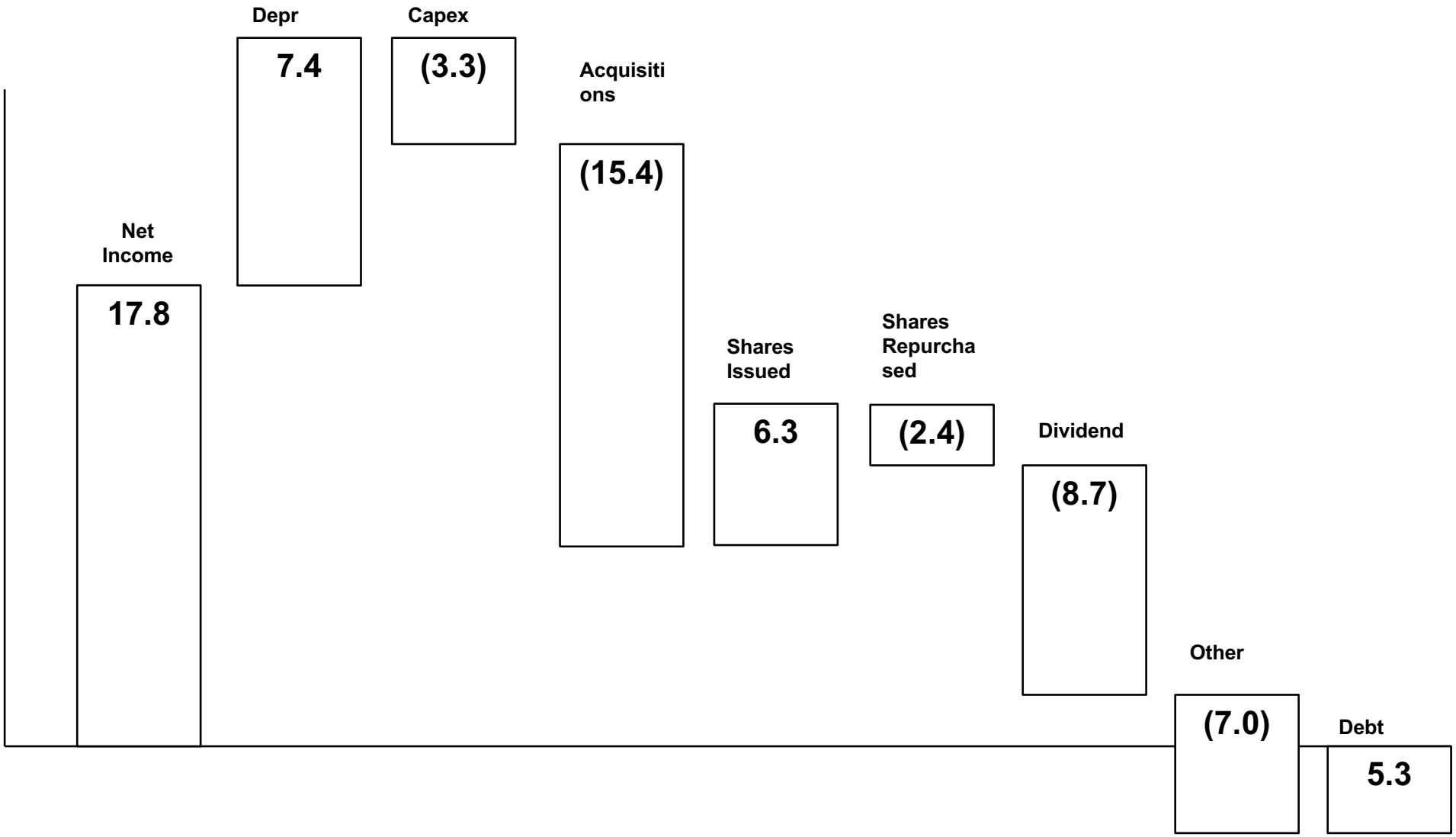
Notes

1996 = 100
Imperial demerged from Hanson 1996, so data unavailable before
TSR = Capital Gain plus Div Yield

1996 – 2016 Annual returns

Inflation 3%
Market 6%
BAT 19%
Imperial 19%

Imperial cash flows 1996 – 2014: Consolidation and cash returns



After 1996 Imperial found a value creating path

Context of long term decline still valid

- **But diversification strategy abandoned**

20 – 30 year strategy emerged to differentiate response to decline

- **Efficiency everywhere**
- **Margin optimisation in mature markets**
- **Profitable growth in growing markets until they decline**
- **Cost synergistic acquisitions**
- **Return excess cash to shareholders**

Within that longer-term value strategy creating medium term value largely about doing enough, quickly enough

Will there be a need for change as all markets decline?

- **Investments in e-cigarettes**
- **Or will global decline still allow many decades of creating value by cash return?**

Do the most accomplished value managers simultaneously plan for medium and long term value creation?

We have seen several examples of companies meshing long term and medium term value creation plans

- Bunzl portfolio clean up and then multi-decade strategy to grow disposables
- Next growth of High Street, then Directory/online growth and store decline
  - Each meta-strategy lasting decades
  - With enough value activities in medium term
- Reckitt consolidation of secondary brands

We have seen companies that failed to focus on value creation

- E.g., Sainsbury (King) investment in low return assets to achieve profitless growth, ditto M&S (Rose), Woolworths (Bish Jones), HMV (Fox) and others just in retailing
- Or most of the banking sector pre-GFC

And there are companies, such as Lloyds, that created great value for a period but who had strategies that did not permit further value creation

- Perhaps particularly prevalent if your value approach is too driven by metrics and not enough by strategy?

Discussion

Should companies have a medium (3 year?) value creation plan, and also a long term (10 - 30 year) value creation plan?

- **Or is there too much uncertainty in the world for this to be useful?**

What would be the process/forum for such discussions?

What do you do?

Agenda

Recap

Value creation of 2003 firms

Managing value over time

- **Lloyds Bank Group**
- **Imperial**

The allocation of capital

- **Share repurchases**

We will adjust the time on this topic according to how much discussion we have on the preceding sections

Quantitative data confirms importance of capital allocation

Data analysis

- **FTSE 350 excluding Financial Institutions and Investment Trusts (n = 242 companies)**
- **2009 – 2016 annual reports**

Broad numbers for this data set (2016)

- **Market capitalization c £1.7 T**
- **Net cash from operating activities c £180 B**
- **Capex c £100 B**
- **Dividends c £ 70 B**

The net cash flow from operating activities has averaged c 13% of market cap

- **An average tenure CEO will allocate between 65 – 75% of a companies market cap in free cash**
- **For most of our long serving (10 – 15 year) CEOs they will invest 150% - 300% of their company's market cap**
- **Unsurprisingly the quality of this activity is a key determinant of value creation**

Buy backs are controversial but used by some great companies

Between 2009 – 16 our 242 UK companies issued c. £ 57 B in shares and bought back c. £66 B in shares*

- **95 companies were net purchasers, 120 net issuers, rest flat**
- **For purchasers they spent an average of 5% of their operating CF on this**

We have used a filter to identify committed buy-back companies

- **Bought back > 5% of issued shares 2009 – 16**
- **Purchase of shares > 5% of net cash from operations (2009 – 16)**
- **"Private equity" returns excluded (Melrose)**

Buy backs interesting because poorly understood, controversial, conducted for a variety of reasons

- **Buy backs about the same size as dividends (2009 – 16)**
- **Similar 50/50% split in US**

* Based on a company's net issue/purchase over those 8 years. Some companies issued shares in some years and purchased them in others, and if each year is taken individually then £83B of shares were purchased and £54B issued

17 companies identified with substantial repurchase programs

2009 - 2016	% shares Repurchased	Cost £m	Cost as % NOCF	Cost as % Mkt Cap
WH Smith	28	371	39	35
Next	24	1,961	42	30
Rightmove	20	427	66	20
JD Wetherspoon	18	167	16	22
Sage	13	614	26	14
AstraZeneca	13	5,833	15	12
Wm Morrisson	11	943	13	15
Qinetiq	11	217	18	18
Relx	11	1,889	47	15
BAe	10	1,534	20	12
Rio Tinto	10	2,395	10	16
Coats	10	156	32	30
Inchcape	9	364	7	6
BAT	7	4,837	14	8
Experian	6	1,492	22	15
Compass	6	1,332	15	9
Imperial	6	1,543	7	6

Source: FAME, Orbis. Companies where BB > 5% shares but not in data set are Computercenter, John D Wood and Vodafone

One way to assess this is the return on buy backs

	No. shares Repurchased	Cost £m	Price/ share	Price 2018 ytd (avg H/L)	Value creation
WH Smith	(43,899)	371	8.45	21.00	+++
Next	(46,427)	1,961	42.24	49.96	+
Rightmove	(23,199)	427	18.40	43.77	+++
JD Wetherspoon	(25,227)	167	6.60	12.14	++
Sage	(168,141)	614	3.65	7.33	+++
AstraZeneca	(185,730)	5,833	31.41	49.58	++
Wm Morrisson	(294,659)	943	3.20	2.18	--
Qinetiq	(73,795)	217	2.94	2.16	-
Relx	(128,374)	1,889	14.71	15.72	+
BAe	(364,630)	1,534	4.21	5.80	+
Rio Tinto	(149,145)	2,395	16.06	38.54	
Coats	(152,508)	156	1.02	0.82	-
Inchcape	(39,379)	364	9.24	7.35	-
BAT	(132,031)	4,837	36.64	44.87	+
Experian	(65,515)	1,492	22.77	*15.89*	
Compass	(97,765)	1,332	13.62	15.03	+
Imperial	(57,751)	1,543	26.72	27.51	+

Uses for free cash

Many of the buy-back companies are highly cash generative with high ROCE

There are limited possible uses for cash generated

- **Leave in cash (earning market interest) or pay down debt (if any exists)**
  - **Current returns 0 – 1%**
- **Make an acquisition**
  - **Which we know on average are value destroying**
- **Invest in capex (+/- working capital)**
- **Return to shareholders**
  - **Dividend, Special dividend, Buy-back**

Companies argue buy-backs give greater flexibility than dividends

- **Easier to move up and down without consequences**
- **Can be adjusted if other needs for cash (capex, WC, acquisitions)**

Nature of major buy-back companies (TBC)

2010- 16 *(rest of data set)*	Value creation	Avg ROCE *(12%)*	Dividend Yield *(3%)*	Capex/ Depreciation *(1.2)*
WH Smith	+++	49	3	0.9
Next	+	47	4	1.0
Rightmove	+++	609	1	0.9
JD Wetherspoon	++	9	2	0.7
Sage	+++	13	3	0.4
AstraZeneca	++	15	5	0.3
Wm Morrisson	--	4	4	1.3
Qinetiq	-	17	2	0.6
Relx	+	17	4	0.1
BAe	+	13	5	0.5
Rio Tinto		6	4	2.0
Coats	-	4	2	0.8
Inchcape	-	12	3	1.6
BAT	+	20	4	0.9
Experian		15	2	*0.2*
Compass	+	15	3	0.8
Imperial	+	11	4	0.2

Wolfson explained Next's buyback philosophy in 2013

BUYBACKS, EPS AND SHARE PRICE

Despite their increasing popularity, share buybacks are still widely misunderstood. There are still those who wrongly believe that they are some sort of share support scheme. This, of course, would be futile as any attempt to support a share price would evaporate as soon as the money ran out.

The only reason share buybacks can deliver long term value is because they *permanently reduce the number of shares in issue* and so increase the amount of profit attributable to each share (EPS). An important part of the logic of share buybacks is the implied link between growth in EPS and growth in share price. Whilst, in the short term there might appear to be no link, in the long run share prices tend to reflect the fundamental value of the earnings and dividend stream. If the share price did not rise with EPS, the buyback programme would eventually leave a single share owning all the profits and dividends!

The graph below illustrates the long term correlation of share price to EPS for NEXT plc over the period we have been buying back shares. The blue boxes indicate earnings per share and the black line shows the share price. The boxes at the top of the chart show the historic price/earnings (PE) ratio.

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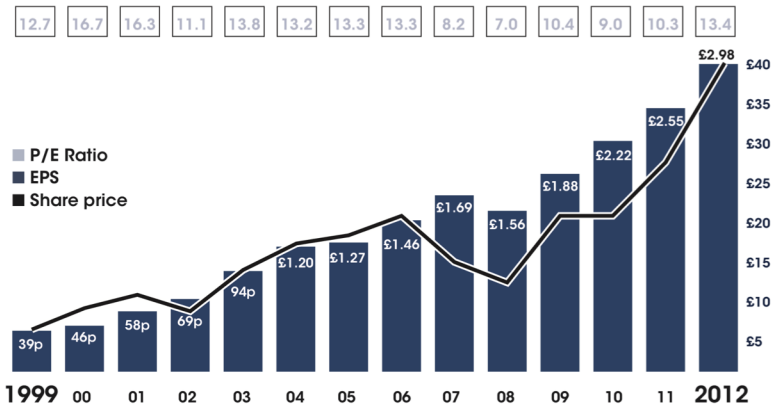

Earnings Per Share and Share Price History

Source: Next 2013 AR

THE LONG GAME – THE NEXT PLC RULES OF BUYBACKS

Over the long term, we have been following these rules when considering buybacks:

1. Share buybacks must be earnings enhancing and make a healthy Equivalent Rate of Return (see below).
2. Only use the cash the business does not need. NEXT has always prioritised investment in the business over share buybacks.
3. Use surplus cash flow, not ever-increasing amounts of debt. We have never allowed our share buyback programme to threaten our investment grade credit status and will not do so going forward.
4. Maintain the dividend at a reasonable level through growing dividends in line with EPS. NEXT will continue to increase dividends in line with EPS.
5. Be consistent. NEXT has been buying shares every year for more than 10 years, reducing the shares in issue by more than 50%.
6. For share buybacks to be an effective use of shareholder cash, the core business must have the prospect of long term growth.

EFFECT ON BUYBACKS OF A RISING SHARE PRICE

The graph above demonstrates that the relationship between our EPS and share price has recently returned to its near historical average. It is important to recognise that this relative rise in the PE ratio reduces the benefit of share buybacks. The more expensive the shares become, the smaller the share of the business can be bought with the same amount of surplus cash.

For example, two years ago when our share price was £21, our operational free cash flow of £200m enabled us to buy 5.2% of the Company. Today with the shares around £40 our expected surplus cash flow of £250m will only buy 3.9%.

The overall effect is simple: as the PE ratio rises the earnings enhancement of buybacks falls. So, given our current PE ratio, how should NEXT assess the desirability of share buybacks?

Essentially there are two measures we look at. The first is the *earnings enhancement* of a buyback when compared to the enhancement to earnings from keeping the cash in the bank and earning interest. The second is the comparison between the earnings enhancement of a buyback compared to the return that would have to be achieved from investing the cash in an alternative investment, the *equivalent rate of return (ERR)*.

With long term borrowing rates for NEXT at around 4%, a share buyback of £250m at £40 would be 2.5% earnings enhancing. The problem with this method of assessing buybacks is that at low interest rates buybacks remain earnings enhancing beyond £60, so we consider the equivalent rate of return measure to be more helpful.

EQUIVALENT RATE OF RETURN (ERR)

The tables below set out the maths used to calculate ERR. The top table shows the enhancement achieved from acquiring £250m of shares at £40, which is 4%. The second table shows that if we were to increase our profits by 4% we would have to invest in an asset yielding 10%. Given that share buybacks carry no additional operational risk, the returns at 10% remain very attractive.

Enhancement £250m Buyback (pre interest costs)	
Share price	£40.00
Market capitalisation	£6,400m
Cash used for buyback	£250m
% Acquired (250/6400)	3.9%
EPS Enhancement 1/(1–3.9%)	4.1%

Calculating ERR	
Company profits	£622m
Additional profit required for 4% growth in EPS	£25.3m
Additional profit as a percentage of £250m invested in buyback (ERR)	10.1%

(These workings are shown as an explanation of Equivalent Rate of Return. Of course, a simpler way of calculating ERR is to divide profit before tax into market capitalisation!)

Rightmove is a notable example

Rightmove is the UK's leading property portal with market cap c £4B

- **Market leader, ROCE > 400%**
- **Highly cash generative (cash conversion > 100% operating profits)**
- **Revenue growth c 15% pa, EPS 20%+**
- **No debt**

Commitment to returning cash to shareholders

- **2007 – 17 returned £865m in dividends and buy back (about half and half)**
- **Bought back >30% of share issue over a decade**
- **Current share price > double average buy-in price**

Rightmove see its priorities for using cash to be

- **Investment in the business**
- **Payment of dividends**
- **Returning excess cash to shareholders via buy-backs**