Ashridge Strategic Management Centre
Members Meeting

21st June 2018

Minutes of Meeting

In attendance

Paul Barrett	Babcock
Tom Ford	Rolls-Royce
Fredrik Gustavsson	easyJet
Horst Kayser	Siemens
Nick Lawson	BP
Belinda Littleton	National Grid
Philip Meyers	ABF
Patrick Scherrer	Helvetia Insurance
Ben Slater	BP
Tara Yamashita	BAe Systems

From Ashridge Strategic Management Centre

Felix Barber
Stephen Bungay
Neil Monnery
Jo Whitehead

Value Management

The meeting was devoted to Neil Monnery's work on value management. In this meeting Neil focussed on managing value over time, based on his analysis a couple of databases and some selected case studies. He ended by briefly considering the issue of buy-backs.

Why Value Creation Matters

Neil began with a short recap. In a public company, value managers are the temporary custodians of assets owned by shareholders. Their purpose is not to fiddle numbers, manage quarterly earnings or ramp the share price up or down, but to build intrinsic value over time. Warren Buffett has called intrinsic value 'a number that is impossible to pinpoint but essential to estimate'. Common proxies are long term TSR and EPS growth, but neither captures it fully. In Buffett's words, in the short run the stock market is a popularity contest, but in the long run it is a weighing machine. The creation or destruction of intrinsic value is manifested in the change in the balance of the scales over time. In creating value for shareholders, companies will inevitably create value for other stakeholders such as customers and employees, but doing this is not the prime goal of the value manager.

There is an enormous difference between the best and worst performers. Between 2001 and 2011, about 25% of the FTSE 350 destroyed value, and 40% earned below the rate of inflation. This represents a tremendous failure, paid for largely by pensioners and holders of life insurance policies. The top quartile, in contrast, earned 9.1% pa against inflation of 3.1%. The average (mean) was 5.5%.

The essence of value management is skilled resource allocation. Effective value managers improve returns on existing assets, shrink assets with poor returns and allocate resources into new value creating activities. Poor performers spend money on ineffective operational improvements, invest in weak businesses without improving their position and fail to shift resources into new opportunities. Weak performers appear to outnumber strong ones, and in considering why this might be, Neil postulated that creating value is a skill distinct from general management. Over the past 10-15 years, general management skills - which are widely taught - have improved, but value management has not. He suggested that the remedy could lie in a mixture of education and a change in mindset, and that the underlying problem was a mixture of complacency and unwillingness to learn:

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?**

-11-

The contrast between business and the sport and military domains might give some clues. Both of the latter not just competitive but adversarial. In professional sport the difference between winning and losing is very clear and the margins very small. That gives rise to a very high willingness to learn, from whatever source, even for the mere possibility of a small improvement. In the military, the difference between winning and losing is not always as clear, but the cost of any armed conflict is high and the cost of failure can be catastrophic. Military historians have produced many studies which explore the reasons for both success and failure. Generalship (the equivalent of value management) is seen as a distinct set of skills from those required of middle-ranking officers (the equivalent of general management). In Britain, it is not possible to be promoted to one-star rank and above without attending the Higher Command and Staff Course at the Defence Academy, the content of which is quite different from the Intermediate Command and Staff Course designed for more junior officers.

There are big differences in attitude towards learning across other domains as well. In his book 'Black Box Thinking', Matthew Syed has contrasted the extraordinary learning record of the aviation industry with the lamentable one of medicine and outlined the differences in attitude and practice.

Neil invited discussion of this capability gap. Comments included:

- Pressure from shareholders who want short-term returns. Neil commented that you do indeed need to have the right set of investors: share-holders, not share-traders. One member company is family owned and this helps a lot because the family has a very long-term perspective. Despite that, management incentives are shorter-term and less aligned.
- Incentives certainly play a role. It is easy to focus on the wrong metric. Sometimes people want to manage for value but it is translated into something too simple such as revenue growth, EPS or EBIT. Growth might be the way to create value, but it is important to place value first. A real value manager is agnostic about sub-goals.
- The cry one often hears is 'we have a business to run', and it is often used to avoid thinking about value creation. Most of the skills a majority of managers are taught have nothing to do with making good resource allocation decisions.
- In point of fact, the CEO's prime task is value creation and one could argue that they should play *no* role in running the business day to day. In practice many do.
- The board has a big role to play as well as the CEO. You cannot rely on one person alone.
- One member company is trying to manage different perspectives: managing the core, growing the core and future growth. This at least serves to devote some resources to the longer term.
- Getting the balance could require a team with different focus among its members: e.g. a CEO to develop and value creating

strategy, a CFO to translate that into value creating activities and a CSO to push for early exits and identify investment opportunities.

Value Creation of 2003 Firms

Neil is working through a dataset of the FT 250 at December 2003 and tracking their TSR for the 12 years ending in December 2015. He aims to map their performance onto value management practices derived from his previous work.

The contrast in performance of this set mirrors that of the FTSE 350 for 2001-2011. Over the twelve years, the top quintile turned £1 into £6.60 and the bottom quintile into 55p, the average being £3. Of the 250 firms, 159 survived, but 91 are no longer independent, most of them having been acquired. Within the top quintile, 7 were acquired. Within the bottom quintile 17 were acquired and another 5 went bankrupt.

One additional observation is that a company's subsequent TSR performance does not correlate with past performance. TSR is a 'clean slate' and multi-period high performance is difficult. This picture changes significantly if rather than tracking companies one tracks proven value managers, such as Habgood at Bunzl, Whitbread and RELX (formerly Reed Elsevier). They tend to be serial value creators and investors should follow them wherever they go.

Among companies, only 8 appeared in the top quintile for three three-year sub-periods, 22 for two and 20 for one. They achieve sustained performance by avoiding value collapses. Only one top-quintile performer appeared once in the bottom quintile. Value destroyers, on the other hand, tend to take big risks that do not pay off or grow in declining markets. There is no relationship between performance and starting position or industry: despite its massive resource and position advantage, Tesco underperformed W H Smith – the overall top value creator - in retailing; in FMCG, Reckitt Benckiser created twice as much value as Unilever; BAT in the declining cigarette business created the same value as the fast-growing chip manufacturer ARM.

Initial testing suggests that high performers follow a set of practices already identified as value-focussed:

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

-20-

This table distinguishes three types of manager – the managerial, goal focused and value focused.

The managerial approach has a wide range of objectives, depending on the operational problem of the moment.

Goal focused CEOs and boards have a limited number of goals, but they only create value when the goals match the way to generate value, so their actual performance varies.

Value managers are very clear that managing intrinsic value is the prime objective. It is at the top of a goal hierarchy, and all subordinate goals are treated pragmatically. Value managers are agnostic as to which levers to pull in order to maximise value and will use different ones according to circumstances. This could mean investing in growth, or cutting back investment, paying higher dividends or buying back shares. Unless value creation is clearly the dominant objective, other goals get in the way of doing so.

Non-value managers have other objectives (most commonly growth) as their primary objective. This may be due to biases, or alternative sets of beliefs which can be reinforced by incentives. Value managers create incentive systems that reinforce the value creation objective and often stand to personally gain very substantially from it.

One Member asked whether there might be some periods in the life of a business when you do not need a value manager. Neil answered that that can sometimes be the case. For examples, a PE owner, who will almost certainly be value focussed themselves, may pick a goal focussed CEO who is good at doing what is needed at the time to create value, and will get rid of them when the environment changes.

Managing Value Over Time

No strategy is valid beyond the specific set of circumstances it was designed to address and the above analysis suggests that value creating strategies need renewal.

Neil explored this issue by drawing on two examples: Lloyds bank which created exceptional value during the decade 1990-2000 under Chairman Jeremy Morse and CEO Brian Pitman (who himself became Chairman in 1997); and Imperial Tobacco, which has also created exceptional value since 2000 initially under Chairman Derek Bonham and CEO's Gareth Davis (till 2010) and Alison Cooper since then.

Morse became Chairman of Lloyds in 1977. Pitman, who joined the bank's Cheltenham branch in 1952, became CEO in 1983 when the bank was slowly recovering from massive losses incurred through sovereign lending in Latin America. After an early discussion about goals, Morse and Pitman agreed to use RoE vs cost of capital, and in 1986 they abandoned the old growth strategy to focus on value. In the early 1990's Pitman borrowed the goal of doubling shareholder value every three years from Coca-Cola.

The value goals helped to transform performance, but Pitman was an early adopter of value management at a time when its techniques had yet to mature, and none of Pitman's goals were the same as intrinsic value. They did not encompass cash generation and the 3-year stretch target may have prejudiced long term value. Nevertheless, between 1983 and Pitman's departure in 2001, by divesting overseas holdings, cutting costs, exiting poor positions and focussing on achieving scale in the UK, the bank achieved a TSR of 26% vs 14% for the FTSE. After that, Lloyds underperformed Barclays till 2007 and in 2008 acquired HBOS with disastrous results.

This story raised the question of whether you need multi-time horizon value agendas. One member organisation is investing heavily in projects with a 30-year horizon, with the existing base revenue baked in. Some shareholders want short term returns, and some want to know the path, which cannot be articulated if it lasts 30 years. Another company is trying to get business units to move from one to three-year plans. At another, the regulatory cycle means that you do not know what you can achieve until settlements are negotiated every eight years. Neil cited the example of Next which operates different cycles, from one year for fashion to 10-25 years for property. In general, one can make early decisions designed to create future options and only commit significant resources when you are familiar with the options and know what works.

Both Imperial and BAT have been significant value creators in an industry which has seen fundamental shifts every 20-30 years since its creation in the 1880's. It is now in a decline which was expected 50 years ago, but it took 20 years to overcome a growth bias. Initially the new strategies adopted involved shifting to low tar and filter products, expanding margins by raising prices and cutting costs, increasing advertising spend (until advertising was banned in 2005), focussing on international sales and using cash flow to diversify, and both BAT and Imperial tracked the market.

In 1986 Imperial was acquired by Hanson, who stopped diversification, sold off many positions, emphasised efficiency and restricted the use of capital. With the IPO from Hanson in 1996, Bonham and Davis took over and adopted an explicitly value-based approach, aligning targets and rewards with TSR, growing dividends and introducing buy-backs. They distinguished clearly between growth markets and mature markets which were in decline. In these they closely managed prices and costs, limited capex and only sanctioned volume growth where it could be profitable. Their two acquisitions, Altadis and Reemtsma, were motivated by the pursuit of lower costs through synergy rather than growth. As a result, between 1996 and 2016, Imperial has achieved annual returns of 19% vs 6% for the market. Within this long-term horizon, creating medium-term value has largely been about pace and ambition: doing enough quickly enough. This strategy may now be changing to one driven more by R&D in e-cigarettes and 'heat not burn' technologies.

This example shows a change in strategy within an enduring value management framework, whereas after Pitman Lloyds either found itself unable to find a value creating strategy or abandoned the value management goal. The group discussed whether it is possible to have both a medium and long-term plan.

One member company has tried to have a discussion of a 5-year horizon, but the CEO was deep in the numbers and said he had no idea what lay that far ahead and so would not consider the future. However, some thought given to this would build awareness and prepare minds for what could come. Some general trends are clear enough.

Another member company does have discussions on the long term because they have such long-lived assets. Predictions do not work, but it is important to ask where there could be value creation opportunities rather than just market opportunities, so that you can set direction by deciding what you have to decide now – and no more. Overall, airlines are value destroying, and Norwegian may be doing so now by buying capacity ahead of time and inflating its balance sheet. They are betting on one future.

Buy Backs

In deciding what to do with cash, buy backs are a controversial option. On the one hand, they are taken to signal that the management believe their shares to be undervalued, but on the other hand they suggest that the management can find no growth opportunities.

Between 2009 and 2016 the amount spent on buy backs was similar to that spent on dividends and between 2009 and 2016, the companies in the UK 250 issued shares worth £57bn and bought back shares worth £66bn, averaging 5% of operating cash flow. Leading value creators are prominent amongst the purchasers. This is partly because they generate a lot of free cash flow and partly because they are unwilling to spend the money on capex or acquisitions unless they believe it will create value.

Neil briefly explained the buy back policies of Next and the fast-growing property portal Rightmove, both of which are highly cash-generative and have consistently bought back shares over a long period when they have cash the business does not need. Neither will borrow to buy back their shares. By reducing the number of shares in circulation buy backs enhance EPS, and are value enhancing when coupled with sustained dividends and the prospect of long-term growth in the business.

We finished the meeting with comments from round the table:

- I think we have some of the value manager, but sometimes we have the managerial focus. We are conservative, have a good debt rating, and manage on ROCE. We occasionally close locations, and we are sometimes biased towards the short term. It would be interesting to learn whether the high performance companies in the database did indeed follow value management principles. TSR is an important metric but it is a bit volatile, so it would be good to see other metrics. The 30-year plan is an interesting concept but it is hard to commit capital to that extent. Perhaps the most fruitful approach is to create optionality – the small bets you can make today.

- There are some things like starting point, endowment and position which you cannot control, so it is about shaping trends and controlling capex. We don't have a 30-year plan, we try to develop the right framework and put the right leadership model in place. I don't subscribe to taking costs out as a way to generate value for the long term. It can't work for ever. You need to be able to regenerate.

- I am from finance. TSR is useful, certainly for the short term, but not when you are trying to decide things like whether to make some bets on battery companies. We are looking at big things such as electrification, how to evolve the company for the future, and we don't have enough to hang on to – we don't know the sources of value yet. You need a balanced perspective. Value is the aim, but you can't use measures based on value for everything. Three years is very short for us – we are capital intensive. We look out to 2040 and beyond at times. That is fundamental to how we position capex for the business. The points around buy backs were interesting. We have dabbled in them, but for us it is hard to know what cash buffer we need. It is often driven by the oil price.

- We have some obligations which go out 100 years but we have at most a 5-year strategy. That means we lack a holistic view of changes in society and the environment which we might be forced to think about if we had a 30-year plan. Start ups will tell you that you don't need a strategy at all, you just have to be agile.

- Our biggest shareholder is a family charity. We want to be around in 50 years, so we take a very long-term view. I think that the pursuit of value management is a bit like the pursuit of happiness – you have to do it indirectly. John Kay in his book 'Obliquity' argues that if you chase it you won't find it. It can lead to setting unrealistic goals, and stupid targets are clearly not valuable. The approach should be to manage the fundamentals of the business and it has to match the situation.

- We have to think very long term. We regularly talk about things like the electrification of aircraft with a horizon of 2040 and beyond. It may be that businesses with longer time horizons and significant R&D spend have to behave differently from consumer goods. Senior managers looking at TSR can only control the controllables and if TSR is driven by things you can't affect, then looking only at that seems odd – which is why people have the balanced score card.

- I love this subject and often bang on about value, but it fails to get traction because the metrics get diluted. Some people fix the numbers. I like the idea of looking at different time periods and looking at different elements of the portfolio for what drives value. I am conscious that you run out of ideas at some point and have to look for other options.

- This session has done real justice to the complexity of the subject. Managing decline is usually done badly, so I found the tobacco story interesting and the idea of repeatability. I like the idea of thinking about scenarios and the longer term when developing strategy. We have a classical planning process with three time horizons. On top, particularly with our current CEO, we are working on 4-year corporate programs with a view out to 2022. Below that are BU plans where we demand top quartile performance and benchmark accordingly, and below that are short term measures like a productivity push. We continuously work on the portfolio. We carry out about 150 acquisitions a year and are continually re-deploying capital. In the last 4 year programme we have made it clear that we work in classical industries but also in digital and software industries, and we are clearly redeploying resources into less capital-intensive businesses. We have made some moves e.g. in our train business, to consolidate the industry by merging assets, not spending capital, and the markets like this. We must continue to find more profitable growth paths. I had felt that achieving a higher TSR would involve taking more risk but actually you seem to be saying the opposite, which is interesting.

- I like the idea of having a value focus. Our strategy team are allocated to both managing the business and future value creation, as you suggest. However, the board will not talk about TSR - I had a section pulled out of a board paper because I mentioned it. They prefer peer analysis. I really liked the case studies about creating value in a declining market and what people can do when they face reality. Everyone knows of areas of long term decline. I would like to see some cases of failure in this situation. We take an engineering-based decision approach which revolves around "least regrets". I am really pleased to see that value creation is not just about TSR. You do need to manage regulatory and reputational risk and to create value for the country.

Future meetings

The next **Members' Meeting** will be held from 13.00 – 17.30 on **27th September 2018**. It will be held at the same venue, The Royal Horseguards Hotel, 2 Whitehall Court, Whitehall, London SW1A 2EJ.

This meeting will be devoted to the topic of innovation strategy and will be led by Rebecca Homkes and our guest speaker Will Bunker. Will is a serial entrepreneur, one-time chairman of Match.com, founder of the angel investor GrowthX and board member of the Silicon Valley Growth Syndicate.

Will and Rebecca will discuss why companies struggle with innovation and suggest that many are just not ready for it. They will introduce the idea of the 'innovation pathway' of 'what', 'where' and 'how'. They will then address the theme of learning from and working with start-ups, a practice which is popular but often fails to deliver, and draw out some lessons about what you can and cannot learn from them. Finally, they will suggest some ways of finding market fit and accelerating your innovation to success, based on a methodology developed and practiced by GrowthX.

Members are also reminded about the next Strategy Team Seminar and our Strategy Bootcamp.

Each Member has two free places on the **Strategy Team Seminars**. The next one is on **Thursday 12th July**, 10.00 – 17.00 at De Vere Venues, Holborn Bars, 138-142 Holborn, London EC1N 2NQ. The subject will be international strategy and will be led by Marcus Alexander.

Our four-day **Strategy Bootcamp** will be taking place on **17th – 20th September** also at De Vere Venues. It is aimed at those in a corporate or BU strategy role who have not received much training in strategy or who would like a refresher. The subjects covered will include strategy development, value creation, strategy tools, strategy and finance, corporate strategy, execution and how to deal with uncertainty.

The fee for the Bootcamp is £3,500 plus VAT and includes lunch and a welcome dinner. Participants are responsible for their own accommodation.

Please let angela.munro@ashridge.hult.edu know if you would like to reserve a place at any of these events for members of your team.