



## Understanding & Communicating Shareholder Value May 2014

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## 1 Introduction

According to Michael J. Mauboussin, chief investment strategist at Legg Mason Capital Management (HBR Blog Network, October 2011):

“A CEO must understand three issues to be effective. First, he or she needs to internalize the true meaning of creating shareholder value. This amounts to a collection of principles that guide strategic, financial, and organizational issues. Second, he or she needs to understand how capital markets work. Finally, he or she must communicate effectively to shareholders, as well as to other stakeholders.”

In this paper, we tackle the true meaning of shareholder value, explain why this is the focus of the capital markets and offer some ideas on how to communicate value creation effectively.

## 2 How does a Company Create Shareholder Value?

A company creates value for its shareholders through a combination of dividends and increases in the share price – the total shareholder return (TSR). The idea is that over a period of time, the average annual TSR meets or beats the return expected by shareholders for the level of risk that they are taking.

This concept of shareholder value was coined by Dr Alfred Rappaport in 1986. However, he reported twenty years later in 2006 that “most companies profess devotion to shareholder value but rarely follow the practices that maximize it.” He argues that with the possible exception of Berkshire Hathaway, no US company gets anywhere near to implementing the principles in full.

In March 2009, Jack Welch, former General Electric CEO, one of the early proponents of shareholder value, made the headlines when he was quoted in the Financial Times as saying “shareholder value is the dumbest idea in the world”.

He was not of course dismissing the importance of shareholder value as a concept. He was merely saying, correctly, that shareholder value is a result, not a strategy – that executives should not single-mindedly aim to increase share prices in the short term. Rather, they should communicate to shareholders that if they make good products, generate trust between managers and employees, customers and suppliers, then profits and the commensurate returns to shareholders will follow.

### 2.1 The Shareholder’s Perspective

Shareholders and their fund managers are in the business of allocating their own or investors’ capital to the investments that will give them the best return, given the perceived level of risk they are taking.

As we have said, shareholders might consider whether a company is creating shareholder value by comparing the total shareholder return (TSR) *over a period of time* to what they could have got in an alternative investment with similar risk.

This is the investors' opportunity cost (the return that they are passing up by making an investment) and is usually referred to as the "cost of equity". If TSR is higher than the shareholders' cost of equity then the company is creating shareholder value.

So what is the time frame over which investors will judge whether they have received an adequate return?

The evidence, in the shape of share prices, is that the market values profits and cash flows a long way into the future. Indeed, a simple discounted cash flow (DCF) model will show you that for most companies, more than half the value ascribed to the shares relates to cash flows which will be generated in more than 10 years' time. There is no doubt therefore that in this respect, the market is long-term orientated.

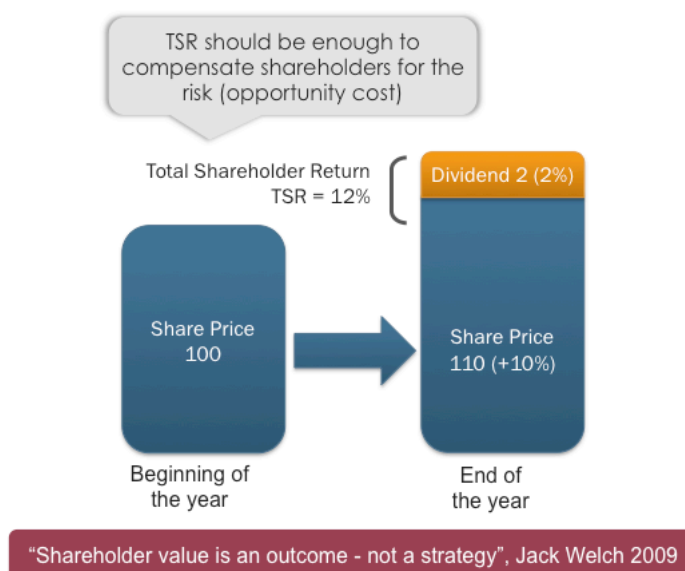
As Mauboussin explains:

"Essentially, investors make short-term bets on long-term outcomes."

### 2.1.1 Total Shareholder Return

TSR is used by many companies as an overall Key Performance Indicator (KPI). This measure of shareholder value is often used in executive compensation to align the interests of directors and shareholders. Typically bonuses will be paid or share options granted if TSR is in the top quartile of a group of comparable companies.

#### Total Shareholder Return



Whilst TSR is useful in helping shareholders evaluate how well one company fares against another company with a similar risk profile and over a similar period of time, it is also problematic.

TSR comprises the dividends together with the share price increase over the period (capital gains). The problem is that whilst management has control over dividends, they cannot (and should not) try to control the share price. Critics of shareholder value quite rightly point out that using TSR as the sole KPI might result in management attempting to drive the share price rather than the business.

In general, if management takes care of the business (which is, after all, what they have been hired to do) the share price will take care of itself. However, this will happen if, and only if, management's efforts are communicated effectively to the market (and we'll come back to this later).

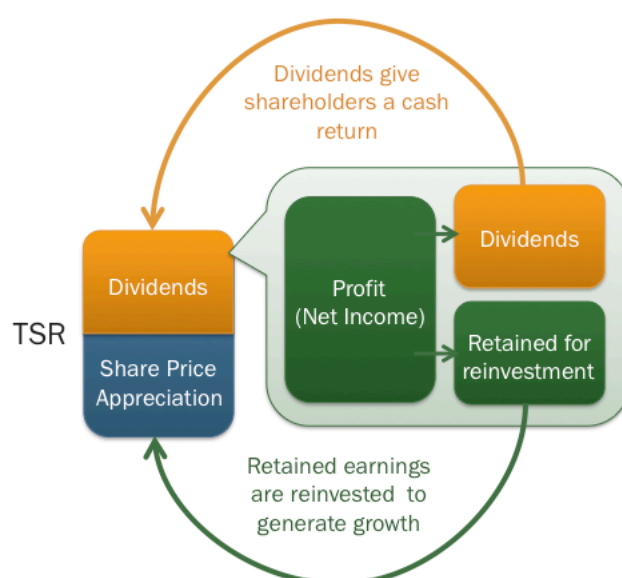
So although TSR is an important measure for shareholders, it is not a KPI which management should use to drive the business. Next, we will see how driving return on capital should, in turn, drive TSR.

### 2.1.2 How TSR links with profits

In the diagram below, you can see how TSR links with profits.

The profit is created for and belongs to the shareholders. Part of the profit is paid out to the shareholders by way of dividends and the rest is retained in the business and invested to generate growth.

#### TSR – the Link with Profits



Dividend policy is clearly an important part of shareholder value. Dividend policy sends a signal to shareholders as to management's expectations of future investment opportunities. A high dividend pay-out suggests either a business that is not capital-intensive, or a mature business with few reinvestment opportunities.

The remaining profit is retained for reinvestment in the business. And we have already seen that shareholders require a return that compensates them for risk. So it follows that profits should only be retained if they can be invested at a rate of return that beats the shareholder's opportunity cost (the cost of equity). Otherwise, shareholders would prefer to have the money back, so that they themselves can invest it. A low dividend pay-out therefore suggests that management have opportunities to reinvest for growth on the shareholders' behalf – i.e. that they can allocate this capital efficiently. Shareholders will of course seek evidence that this is in fact the case by seeking to understand the capital allocation process and the subsequent return on new investment.

## 2.2 The Company's Perspective on Shareholder Value

From the company's point of view, therefore, it is crucial to measure the return on capital, to ensure that this meets or beats the expectations of investors.

### 2.2.1 ROE or ROCE?

The simplest way to measure returns is to calculate the return on equity (ROE) and compare this with the cost of equity. ROE is the net profit attributable to shareholders as a percentage of the equity (usually either average or year-end equity).

However, the majority of companies are of course funded by a mixture of equity and debt. And this means that ROE can be manipulated by reducing the equity (and increasing debt), thereby raising risk.

There are therefore relatively few sectors in which ROE is the best measure of returns. The most obvious examples are banking and insurance, where regulations require companies to maintain "capital adequacy" – i.e. enough equity to ensure that any potential losses can be absorbed without harming customers. These capital adequacy rules prevent companies minimizing equity beyond a certain level.

For most sectors, a better measure of returns is return on total capital, which uses operating profit (after tax) as a percentage of equity plus debt (average or year-end). We'll call this return on capital employed (ROCE)<sup>1</sup>.

The post-tax ROCE must then be compared with the weighted average cost of capital (WACC) to determine whether the company is making an economic profit.

### 2.2.2 Cost of Capital

The cost of equity is the return that the investors expect to compensate them for the risk they are taking. It is not a cash cost, but an opportunity cost, representing the return that the investors are passing up by making an investment - the return that they could get from an alternative investment with similar risk characteristics.

A great deal of academic research has been dedicated to estimating the cost of equity. The most commonly used model is the Capital Asset Pricing Model (CAPM), which assumes that investors require

- At least what they could get risk-free (say, in long-term Government bonds) – approximately 4-5%
- Plus a premium for the extra risk of investing in shares (the "equity risk premium") – approximately 3-9%

At the time of writing, the risk free rate is very low by historical standards in developed markets (well under 5%) and the equity risk premium is probably high by the same standards.

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<sup>1</sup> Alternative terminology would be ROACE (return on average capital employed) or ROIC (return on invested capital).

For purposes of illustration, we'll assume that the cost of equity in developed markets<sup>2</sup> is likely to be around 10%.

The cost of debt is the interest rate that the company has to pay, after tax (because interest is tax-deductible). So if a company pays average interest on debt of 6% and its effective tax rate is 20%, the cost of debt would be 4.8% ( $6\% \times (1-0.2)$ ).

For purposes of illustration, let's assume that the cost of debt is around 5%.

### Example WACC Calculation – Volkswagen

Assets	Debt @ 2.6%	Equity @ 11.2%	%	2013	2012
			Risk-free rate	2.6	2.2
			MSCI World Index market risk premium	6.5	6.5
			Volkswagen-specific risk premium	2.1	1.7
			(Volkswagen beta factor)	(1.32)	(1.26)
			Cost of equity after tax	11.2	10.4
			Cost of debt	3.7	3.7
			Tax	-1.1	-1.1
			Cost of debt after tax	2.6	2.6
			Proportion of equity	66.7	66.7
			Proportion of debt	33.3	33.3
			Cost of capital after tax	8.3	7.8

VW – 2013 Annual Report – page 107

### 2.2.3 Return on Capital

Consider the two companies below, both of which are funded by a mixture of debt and equity.

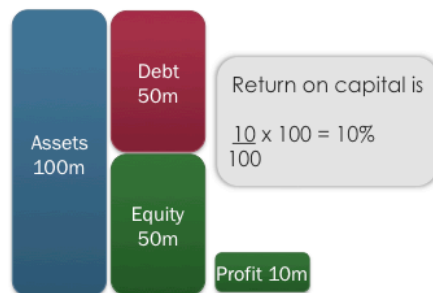
Both companies make an annual profit of 10m. However, company A is generating that profit with only 100m of assets/capital whereas company B is using 200m of capital to generate the same profit.

<sup>2</sup> In developing markets, the cost of equity tends to be higher due to higher risk-free rates and higher equity risk premia.

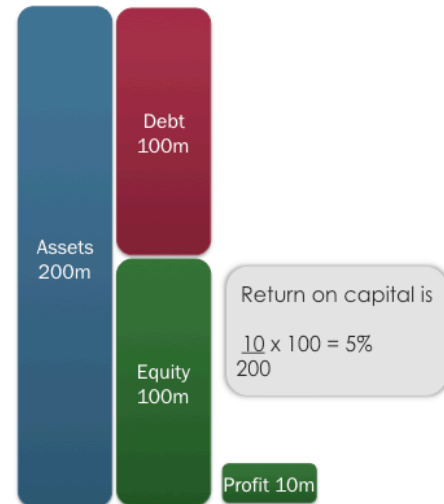


### Return on Capital Employed

A



B



Company A is clearly doing better than company B. Investors are getting more profit for each unit of capital – i.e. a better return on capital. Company A is generating a return on capital of 10% whereas company B's return on capital is just 5%.

### 2.2.4 Economic Profit

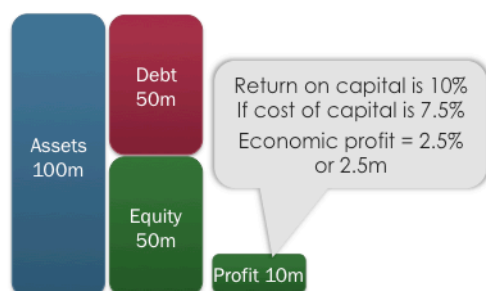
If we assume that the average cost of the capital is 7.5% (the blended cost of the equity and the debt), we could conclude that company A is creating value as it is making a return on capital that exceeds the cost of the capital.

Company B on the other hand is borrowing capital at 7.5% and generating returns of only 5% - i.e. it is destroying value.

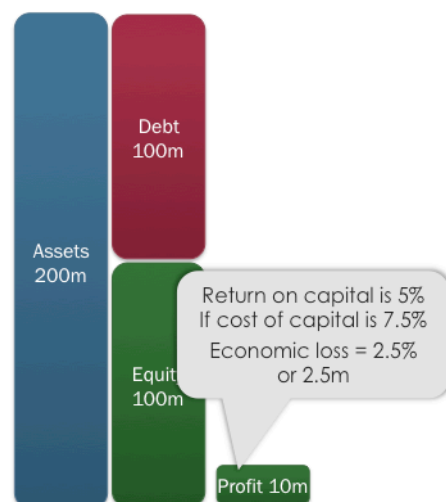
The profit (or loss) made over the cost of capital is known as economic profit (or economic loss),

## Economic Profit

A

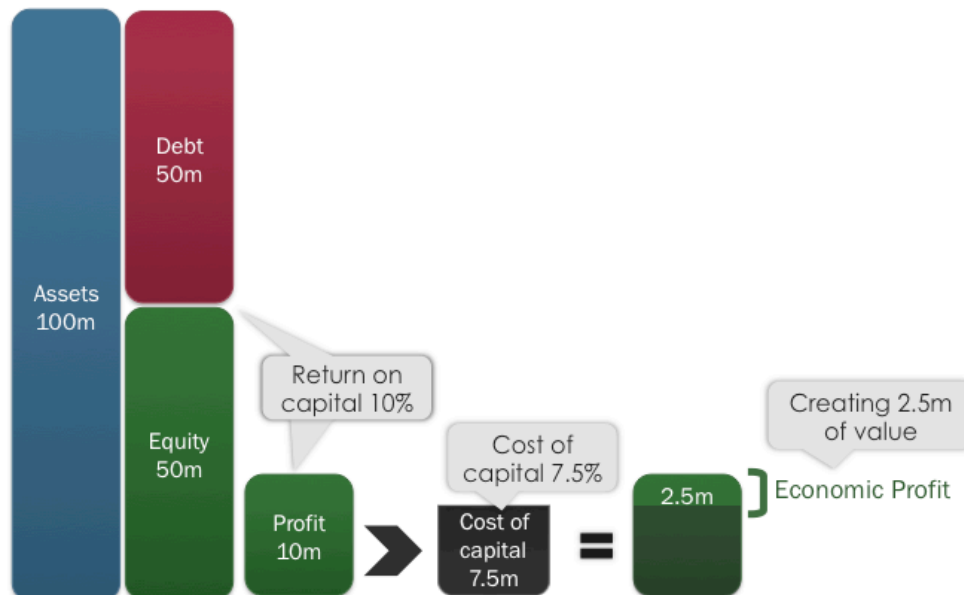


B



Note that from the shareholders' perspective, once the interest is paid on debt, all the extra profits belong to them, so as the return on capital increases, the shareholders gain, whereas the lenders do not.

## Value Creation Summary



### 3 Communicating Value Creation

Although many companies use economic profit internally for decision-making (particularly in investment appraisal, where a positive net present value is a very similar concept to economic profit), relatively few communicate it externally to investment audiences.

There are probably two main reasons for this.

- First, it is relatively difficult to measure the amount of capital that has been invested in the business – for example, how should R&D, marketing, leases etc. be treated in the calculation of economic profit – as assets or expenses?
- Second, there are differing views on how the cost of capital should be measured.

#### Example – Diageo (from 2013 Full Year Results)

Economic profit is a non-GAAP measure that is used by management to assess the group's return from its asset base compared to a standard cost of capital charge and is calculated to aid evaluation of the performance of the business.

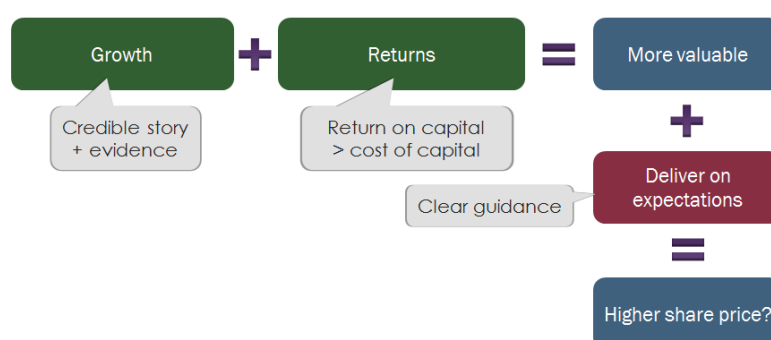
The profit used in assessing the return from the group's asset base and the asset base itself are the same as those used in the calculation for the return on average total invested capital (see above). The standard capital charge applied to the average total invested capital is currently 8%, being management's assessment of a constant minimum level of return that the group expects to generate from its asset base. Economic profit is calculated as the difference between the standard capital charge on the average invested assets and the actual return achieved by the group on those assets.

Calculations for economic profit for the year ended 30 June 2013 and 30 June 2012 were as follows:

	2013 £ million	2012 £ million
Average total invested capital (see 4 above)	19,142	17,464
Operating profit	3,431	3,158
Exceptional operating items	99	40
Share of associates' profits after tax	199	213
Tax at the tax rate before exceptional items of 17.7% (2012 – 17.7%)	(660)	(604)
	<u>3,069</u>	<u>2,807</u>
Capital charge at 8% of average total invested capital	<u>(1,531)</u>	<u>(1,397)</u>
<b>Economic profit</b>	<u><b>1,538</b></u>	<u><b>1,410</b></u>

In very simple terms, even if companies are not comfortable articulating economic profit, they can still evidence value creation by demonstrating growth at the same time as managing returns and by communicating both of these effectively as illustrated in the graphic below.

#### Value Creation – The Whole Story



There is no magic formula, but companies who start to articulate this story and keep the market well informed by managing expectations have, in our opinion, a fighting chance of seeing their share price reflect fundamental value.

Implicit in this way of telling the story are four key issues to consider and communicate:

1. How the company will grow
2. How the company manages returns
3. How the company manages its capital base to ensure a low overall cost of capital
4. How best to manage market expectations.

We will now consider each of these in turn.

### 3.1 Growth

Since value is created over the long-term and company valuation is forward looking, clearly analysts and investors need to be able to understand where growth is coming from in future.

Growth, however, has a cost and companies must invest to achieve it. The key is to invest in opportunities which can make a return on capital which exceeds the cost of that capital – i.e. opportunities that are economically profitable, not simply those that make an accounting profit. Growth must never be at the expense of returns. It is therefore vital for companies to explain how they evaluate growth opportunities and how they subsequently judge the success of their investment.

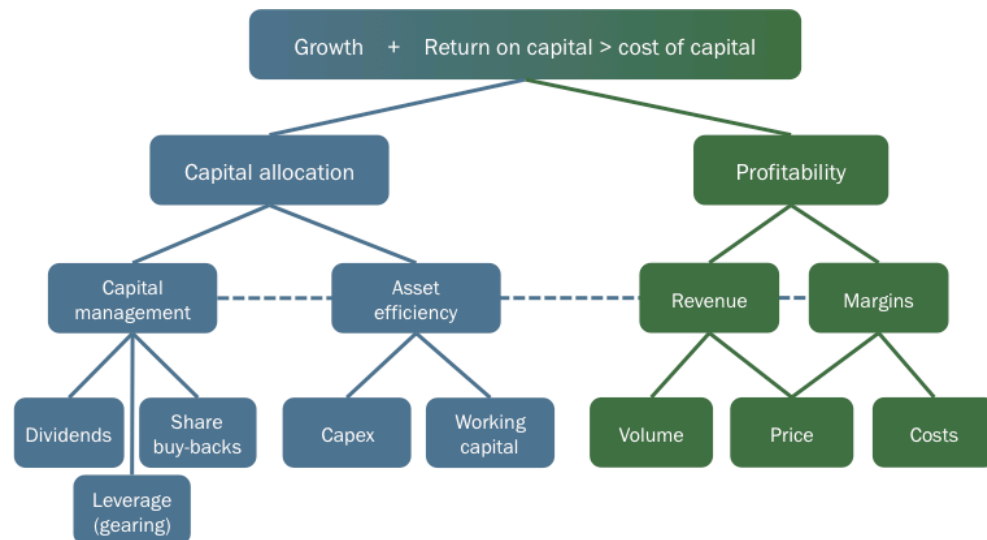
The growth story needs, of course, to be credible. It is much easier to accept the prospect of rapid growth in a rapidly growing market than in a mature market with lots of competition. It helps to be clear about which divisions are generating growth, what resources they need, what timescale is realistic and why your company is going to succeed rather than others (i.e. the market needs convincing that you have the financial and managerial resources to deliver).

Growth must be generated by good performance in the underlying business (strong volumes and prices and close attention to cost control) if it is to command a high valuation. Growth which is unsustainable (e.g. due to one-off factors) needs to be discussed separately from the core business and will inevitably attract a lower valuation.

This is why analysts try to establish “one-off” contributions at results meetings to get at the underlying performance of the business and make it easier to forecast future profits without all the “noise” from short-term decisions that may have helped the results but not the business.

Credibility will depend to a large degree on the management’s track record and ability to deliver on both the company’s promises and the market’s expectations – see “Managing Expectations” below.

### Driving Growth at the Required Return



## 3.2 Returns

One of the key ways to improve shareholder value is to improve return on capital. The diagram above shows how return on capital combines efficient capital allocation and profitability.

There are 4 key levers to pull here:

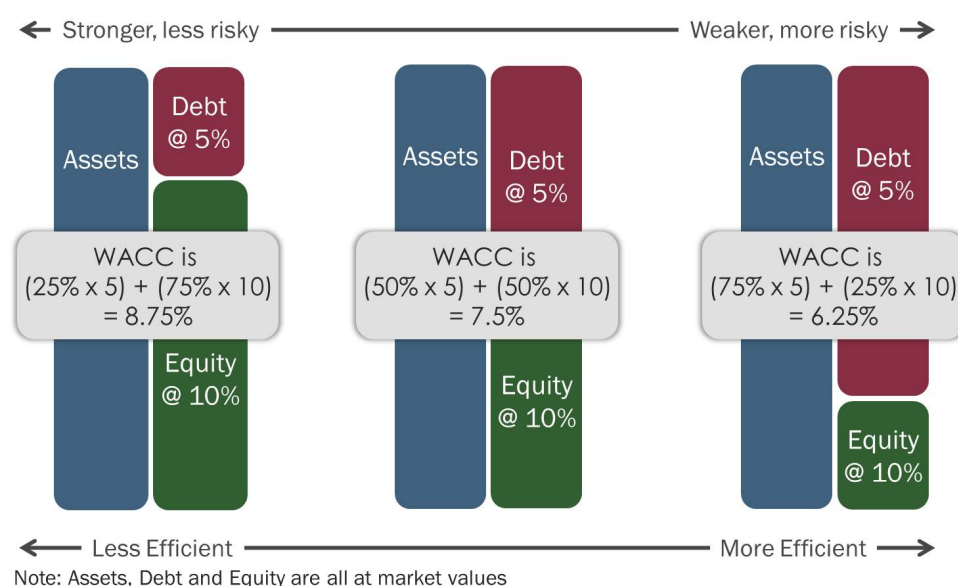
1. Manage capital
2. Allocate capital efficiently
3. Maximise asset efficiency
4. Maximise profitability.



## 4 Capital Management

One way to improve shareholder value is to reduce the cost of capital. This is often referred to as having an “efficient” balance sheet. The idea is that a company should seek to minimize the cost of capital by having an efficient mix of equity and debt.

### 4.1 Efficient Balance Sheets

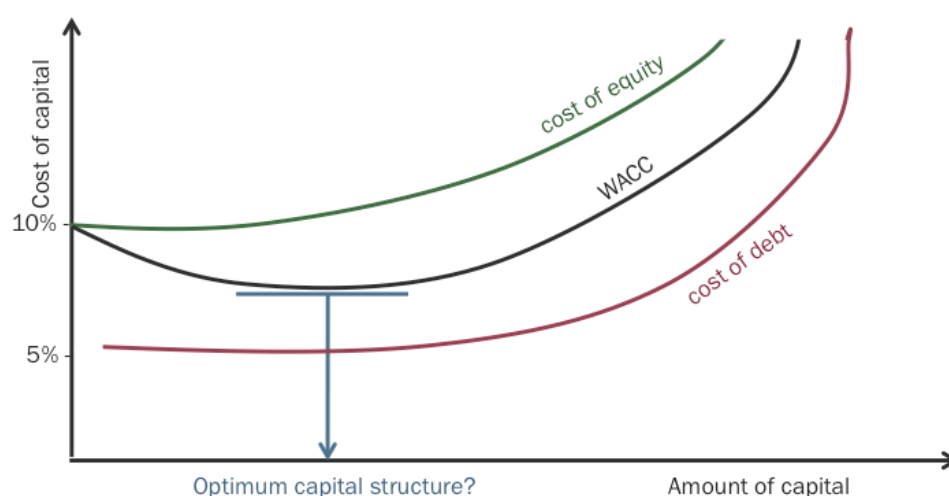


On the face of it, the diagram above suggests that all companies should be predominantly debt financed. However, the picture is too simplistic.

Debt financing means compulsory interest payments and a defined capital repayment schedule, regardless of how well or badly the company is doing. So just like an individual having a large mortgage, high debt generally means high risk (unless profits are extremely stable in all economic conditions - e.g. a utility).

Shareholders will accept a certain amount of debt, depending on their perception of the inherent risks in the business and hence the likely variability of profits. When a company's capital structure exceeds that amount, the cost of equity will increase because the shareholders will require a higher return to compensate them for the extra risk. Any further increases in debt may then increase the overall weighted average cost of capital (WACC) rather than reduce it.

## The Optimum Capital Structure



So, companies should have an efficient capital structure that minimizes the weighted average cost of capital but does not create too much risk.

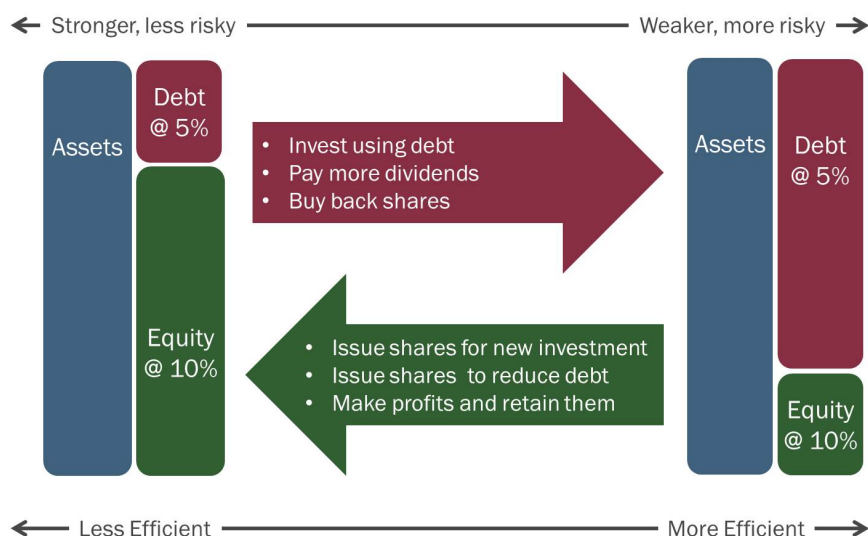
Of course over time, the capital structure will change. If a company makes and retains profits, this will grow the balance sheet and increase the equity proportion of funding. Companies therefore need to actively manage their capital and may need to take action to change the mix.

## 4.2 Changing the Capital Structure

Shareholders will expect the balance sheet to be managed using a mixture of:

- Capital raising (debt and equity)
- Dividend policy
- Share buy-backs.

### Changing the Capital Structure



## 4.3 Capital Management

You can see here why it is so important to explain to investors management's attitude to capital management.

Investors would like to understand

- What capital structure management feel is appropriate for the business
- How funding needs will be met
- How new capital will be deployed (e.g. acquisitions, organic growth etc.)
- How management will deal with surplus capital (dividend policy and share buy-backs<sup>3</sup>).

A clearly stated capital management policy underscores the board's commitment to shareholder value.

## 4.4 The Role of Risk

We've seen that shareholders require a return that compensates them for the risk they are taking – the higher the risk, the higher the expected return. So increasing risk can be expected to raise a company's cost of capital.

Perceived risk and expected return are linked, so risk assessment and a description of risk mitigation will be an important element of analyst and investor communications.

This should include:

- Specific business risks
- Acquisition-related risks - the market is often cautious about the value of growth that is delivered by deals.
- The extent of the operational gearing/leverage (how high the fixed costs in the business are as a proportion of total costs)
- Financial gearing/leverage – a description of the capital structure and why it is appropriate - leveraging up (using more debt to finance the business) and share buy-backs both increase earnings – but this may be achieved at the cost of increased risk.

## 5 Efficient Allocation of Capital

At the heart of returns is efficient capital allocation – only allocating capital to activities that will make returns that will compensate for the risks involved. This is a concept that is at the forefront of investors' minds – after all, it is what they themselves do for a living.

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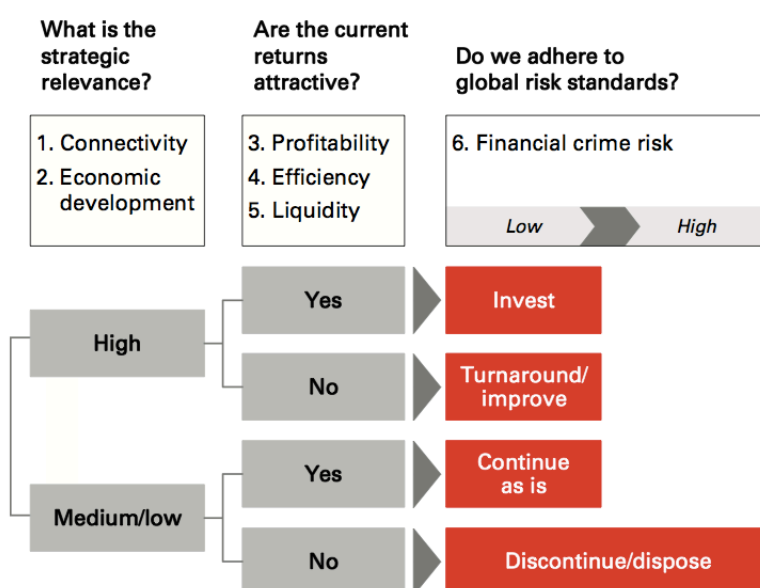
<sup>3</sup> Because dividends tend to be taxed immediately in the hands of investors, buying back shares can be a good alternative, especially for one-off returns of capital. Of course capital should only be allocated to buy-backs when management determines (through their own internal valuation model) that the shares are cheap.

Investors will therefore be keen to learn more about the capital allocation process – how management makes investment decisions.

In addition to how new capital will be deployed, investors will want to know how existing assets are being used to their maximum efficiency (including the disposal of non-core assets).

Example – HSBC (from 2013 Annual Report)

### *Using the six filters in decision-making*



## 6 Maximising Asset Efficiency

Return on capital can be improved by using assets more efficiently by making physical capital assets and working capital work harder and more effectively – producing and selling more from the same asset base and controlling working capital, even when sales are growing.

Measures related to asset turnover such as sales per square foot in retail, inventories turnover, receivables collection period (days' sales outstanding) can be useful here to monitor asset efficiency as the business grows.

## 7 Maximising Profitability

Return on capital can be improved by increasing profits. This could be achieved by growing revenue faster than costs, or by cost-savings – both of which will grow margins.

Of course each individual business will have its own key performance indicators (KPIs) – the important thing is to link these so that it is clear to shareholders how the company is being run in their best interests.

This linkage is also important in internal communications – at the heart of value-based management is the idea that all employees should be able to understand how they can contribute to value creation by improving their own KPIs.

## 8 Expectations Management

One of the key risks faced by investors is the risk that management may not be able to deliver on the company's stated strategy.

Companies need to present a convincing, credible management team, with a realistic view of the prospects for the sector and the business. A crucial part of this is that management must be able to set expectations accurately and deliver accordingly.

The aim of forward looking information and earnings guidance is to bring analysts and investors closer to the way that management views the business, thus improving the market's understanding of the dynamics of the business and its potential.

Here are some suggestions for best practice:

- Link KPIs clearly to strategy
- Set medium-term targets for KPIs and explain progress against these targets.
- Even if you choose not to give any guidance, analysts still have to forecast. If results fail to meet those market expectations, management will get the blame anyway. Additionally, if market expectations are out of line with reality, then the company should issue a trading update (often a profit warning). Giving some guidance should help to avoid this.
- The quality of the guidance is more important than the quantity.
- Use ranges rather than single or "consensus" numbers.
- Be consistent.
- Guidance should be on an absolute basis and relative to the external environment.
- Disclose the underlying economic assumptions behind company forecasts to avoid the need for a corrective announcement due to factors outside the company's control.
- Disclose sensitivity to commodity prices, exchange rates, interest rates etc.
- Provide industry research, including potential growth rates, to back up growth assumptions.
- Testing your guidance statement by running it through an internal model is often useful, especially when you are updating it.
- Monitor your internal forecast against those in the market on a regular basis, e.g. monthly and consider updating the market as necessary (as required by regulations in most markets).
- If revenues or costs are inherently difficult to predict, then endeavour to find and disclose other targets to demonstrate management quality.

Meeting expectations on a regular basis is the best way to demonstrate quality of management. Missing expectations, especially with no warning, is likely to have a very detrimental effect on share price and the credibility of management. And once credibility is lost, it takes a long time to re-build. Recovery may be accelerated by setting and delivering on a series of small, short-term, achievable targets.



## 9 Improving Shareholder Value - Summary

Value-creating companies will:

- Be aware of their cost of capital
- Minimise the amount of capital used
- Minimise the cost of that capital
- Allocate capital to activities that create the highest return for the least risk
- Work on improving return on capital
  - Improve profit by driving revenues and controlling costs
  - Improve efficiency by controlling capital expenditure and working capital.

## 10 Communicating Shareholder Value – Summary

Excellent communicators will:

- Explain that their overarching objective is to create value for shareholders
- Explain their strategy for value creation and how they will measure performance using KPIs
- Explain how they will measure progress, including setting targets for KPIs
- Explain how they link executive compensation (management's returns) to the same measures.

## 11 Current Debates on Shareholder Value

Apart from “shareholder value is a result, not a strategy” which we have discussed in 2 above, there are a number of other debates which we cover below.

### 11.1 Shareholder Value and Short Termism

We've seen that shareholder value can be viewed from two perspectives:

- The perspective of the shareholder
- The perspective of the company

Of course both shareholders and companies are in the business of allocating capital to the most profitable activities, so both should share a common view.

However, there is an issue of timescale. Research suggests that the average holding period for shares in professionally managed funds has dropped steadily over the last 40 years from around 6 years to less than one year today. This is often cited as evidence that the market is short-termist.

Rappaport argues this shorter average stock holding period does not matter. What does matter is the market's valuation horizon – the number of years of expected cash flows required to justify the share price – which studies show to be at least 10 years. If this is the case, then the market should still be making decisions based on the long term.

In fact, traditional long term investors such as pension funds and life insurance companies typically have liabilities extending over a 25 year period or even longer. Such investors should have a real interest in companies that generate shareholder value over the long term.

Equally, companies that commit to shareholder value maximization should be able to attract these long term investors.

However, other investors do seem to have shorter timescales – mutual funds (and many hedge funds) for example, must justify their performance on an annual and even quarterly basis in order to attract funds or prevent funds from being withdrawn. Such pressure may push such funds to invest more on the basis of momentum than value.

This in turn puts pressure on companies to perform in the short term. There is no doubt that companies who fail to deliver on earnings promises suffer from substantial share price falls and therefore potentially loss of shareholder value. The problem is that decisions made to maximize short term profits or meet earnings targets may not be those which create long term value, so keeping short term investors happy may in fact mean that long term value creation is neglected.

On the other hand, following the shareholder value route may mean making the company less attractive to shorter term investors, who are responsible for much of the day-to-day trading (and therefore influence share prices significantly).

## 11.2 Share Options and Other Incentives

As we have said, many companies link incentives for senior executives, such as share options to TSR (total shareholder return). The idea is that executives' interests are aligned with those of shareholders.

There are a number of problems with this:

- Using TSR creates a direct link to share price, which might incentivize executives to play the share price in the short term at the expense of long-term value creation.
- Incentives often involve share options with vesting periods of around 3 years. This could incentivize executives to take short-term decisions with potentially high return and risk to the detriment of the period after executives have cashed their options in.
- In a bull market or a bubble, share options can result in high returns for executives for below average performance. Similarly, in a bear market, share options may lose their ability to motivate at all.
- Executives may be motivated to change the peer group for comparison purposes on a regular basis in order to show performance in a more positive light and trigger rewards.
- Executives in a poorly performing operating unit may be rewarded even though their unit's performance has been substandard. Similarly, executives in an operating unit which is performing well may not be rewarded if the whole is under-performing, which is likely to be demotivating.

- We would argue that executive compensation should be linked to internal measures of value creation, instead of or in addition to TSR. Requiring directors to buy and hold shares, instead of awarding options would arguably replicate the risks as well as the rewards of share ownership.

## 11.3 Shareholder Value and Leverage

Shareholder value has been criticized for encouraging companies to leverage up excessively. During the 1990s and early 2000s, many companies faced pressure from investors to return cash to shareholders and leverage up the balance sheet. Some of those who failed to oblige were bid for by Private Equity firms in leveraged deals that did the job for them.

The impact of the credit crunch and global recession left some companies which had “efficient” balance sheets dangerously exposed as they faced falling profits and problems renegotiating debt in poor credit conditions.

Subsequently we have seen an era of unprecedented low interest rates that have allowed companies to borrow extremely cheaply. It will be interesting to see how the market adapts to the higher rates that will inevitably come with recovery.

## 11.4 Focus on Earnings Per Share

Many companies use EPS and/or EPS growth as a key performance indicator. And many equate this with value creation, even though EPS take no account of the cost of equity (which of course is not provided free by shareholders).

Of course, EPS is useful shorthand for profits. And it’s very easy to get a quick measure of a company’s valuation by comparing EPS to the share price (the P/E ratio or multiple), which is the ready reckoner the market uses to assess value.

However, investors know that it is perfectly possible to grow earnings at the expense of returns, and in addition, EPS is manipulable by taking on leverage. So a company that simply communicates around earnings, without talking about the investment required to grow those earnings is missing a trick.

Our advice would be to communicate around both earnings and returns.

## 12 Lessons for Investor Communications

Clear communication of the creation of shareholder value is strongest when all the elements or “levers” are addressed:

- Communicate your strategy and then explain how it will create shareholder value
- Explain your decisions (eg acquisitions, investments, disposals) in the context of long term value creation and don’t worry so much about the impact on near-term earnings
- Communicate your competitive advantage and KPIs and how they drive long term value
- Explain how you drive shareholder value internally at all levels
- Give guidance based on KPIs (ie targets) instead of or in addition to specific profit numbers
- Explain your capital structure in the context of risk versus the efficient balance sheet
- Explain how you make capital allocation decisions internally
- Communicate dividend policy clearly
- Return spare cash to shareholders (subject to funding requirements)
- Ensure management incentives are linked to long-term returns and not short-term share price performance.

## 13 An Institutional Investor's View

The extracts below are from “The Hermes Responsible Ownership Principles – What we expect of listed companies and what they can expect of us”.

### Strategy:

#### **Principle III (corporate and business unit strategy)**

Companies should have and continue to develop a coherent corporate strategy and strategies for each of their business units. These should ideally be expressed in terms of their target markets and of the competitive advantage the business has in exploiting opportunities in them in order to generate sustainable returns in excess of the cost of capital. The company should understand the factors which drive the relevant market, and the particular strengths which underpin its competitive position. Companies should also be able to explain why they are the “best parent” of each of the businesses they run.

Long-term shareholder value requires the generation of return well into the future. If shareholders are to assess the degree to which a company will generate long-term value, they will need to understand the corporate strategy and the strategies of its business units. We believe an appropriate requirement is that boards should be able not only to discuss the objective of strategy, but also the methods by which that objective is to be achieved.


#### **Principle V (investment plans)**

Companies should ensure that all investment plans have been critically tested in terms of their ability to create long-term shareholder value. If a company is considering diversifying from or rapidly expanding its core business, especially if by acquisition, it should apply significantly higher hurdles within such tests to reflect the greater risks inherent in such a strategy.

#### **Principle VII (appropriate cost of capital)**

Companies should have an efficient capital structure which will minimise the long-term cost of capital. Where the capital structure is inefficient taking the particular circumstances of the company concerned into account, the balance of debt and equity should be reconsidered.

If you would like FinanceTalking to help you with financial training and/or communication ideas in this area please contact us on:

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