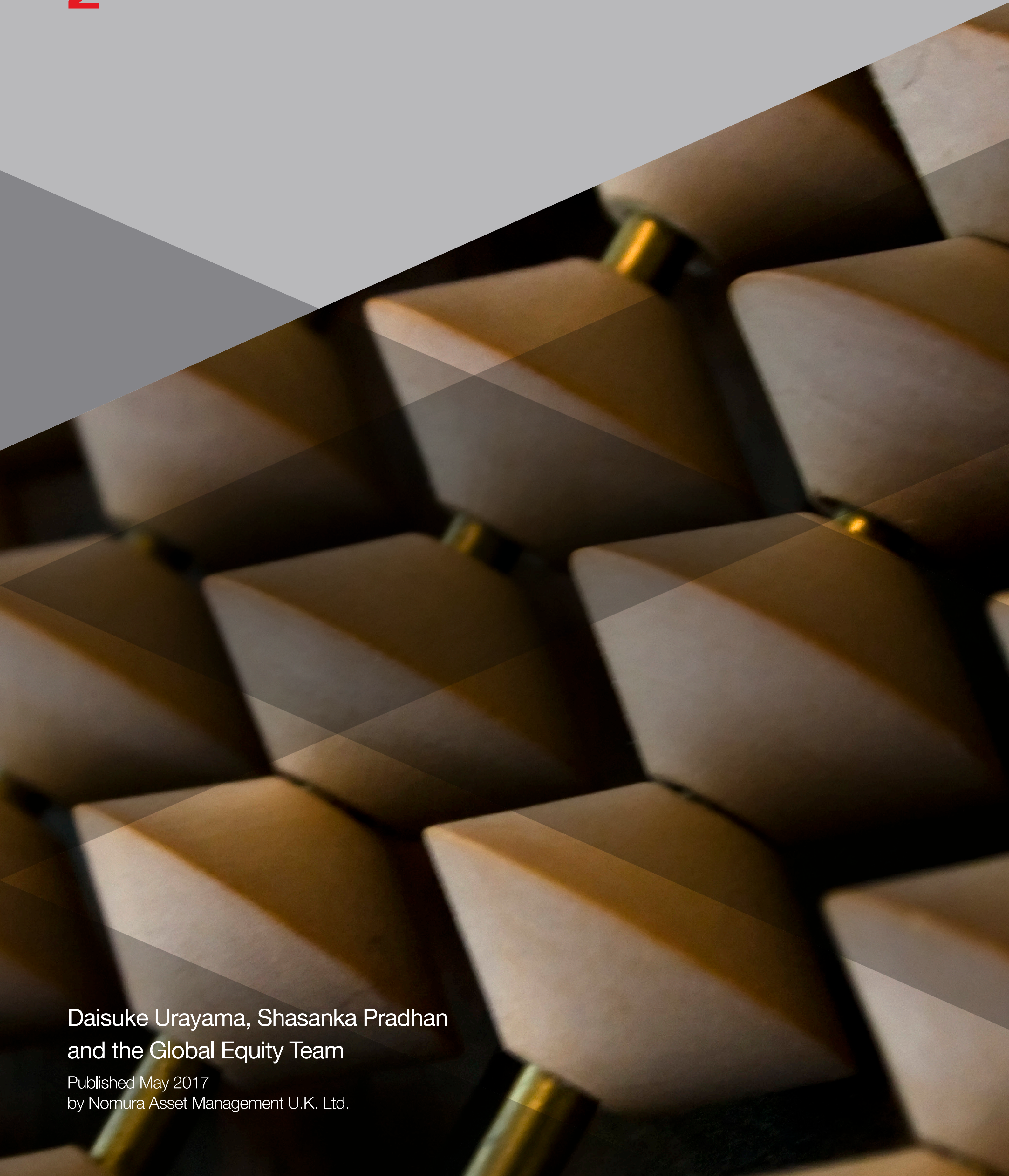
NOMURA ASSET MANAGEMENT U.K. LTD.

Nomura's Global Equity Team on Cash Return to Shareholders



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There is a mathematical series, well known to man, but often misunderstood. It is at the heart of the concept of “long term investing”, but investors often act counter to its mathematical laws. The mathematical series is geometric, but commonly goes by the name ‘compound interest’. Its passage of time magnifies its impact on investment results, amplifying profits and making losses hard to recover from. It makes repeatability and the avoidance of substantial declines in investment values key components of a long term investment strategy. Our investment process is designed with this in mind. We look for “Quality at Discount Valuation” and with this philosophy we aim to repeatedly find investments that are priced too cheaply and are unlikely to irreversibly decline in value.

This note is part of a series of four that looks at our definition of “quality”, which may differ from other investors. We aim to invest in ‘decent’ quality companies according to four key quality characteristics. This note looks specifically at the importance of cash return to shareholders.

***Quality:* Strong competitive advantages, consistent cash returns to shareholders, skilled management, a history of attractive returns on capital and the opportunity to make attractive reinvestments are characteristics of “quality” companies. These companies can often sustain their returns for longer than the market recognises or are less likely to experience irreversible declines in profitability**

We like to invest in companies that have the ability to generate good returns on invested capital and have the opportunity to re-deploy those returns in attractive investment opportunities. However, companies that generate good returns on invested capital don't always have attractive reinvestment opportunities. In such a case, the best thing for a company to do is to return excess cash to shareholders and we think companies that consistently do so are making a positive statement about the company's strength and about the quality of the company's management.

There are three things we can say about a company that consistently returns cash to shareholders:

- First, the company can consistently generate cash from its operations;
- Second, the management has the judgement to determine that the reinvestment opportunities available are not attractive enough;
- Finally, the management has the discipline to not spend money anyway.

What do we mean by consistent return to shareholders? We like to see companies paying a sustainable level of dividend with an ability to grow that dividend over time. Growth in dividend indicates that the company has the opportunity and the ability to grow free cash flow(1), which is always a good sign. However, when it comes to share buybacks, the decision of how much a company should spend on buying back shares is more nuanced than how much to pay in dividend. In the case of dividend payment, what the company pays is what all shareholders get (after taxes, of course), which is relatively straightforward. However, share buybacks are purchases of a company's shares by the company itself and like any purchase, we, as long term shareholders, want the company to get the best value. A company can make sure it is getting a good value by buying back shares only when share price is below its intrinsic value. So we would like companies to be opportunistic when buying back its own shares and not keep increasing the amount they spend on buying back shares every year regardless of the share price.

We think Texas Instruments (a US semiconductor company) is an example of a company that follows what we consider to be an optimal cash return strategy. It has increased dividends every year for the past 11 years and in addition to that, it buys back shares when share price is below its assessment of intrinsic value. So we can be assured of consistency in cash return through dividends and we can also take comfort in the fact that the company is getting the best value for its long term shareholders when it does share buybacks. Its stock has achieved a wonderful total return of 190% over the last five years.

Another example of a company with a good capital return track record is Altria, a tobacco company in the US that manufactures Marlboro and L&M brand cigarettes. It has generated return on invested capital of around 15-20% in the past few years. However, smoking rates in the US have fallen consistently for the past 50 years, which means the return the company can achieve by investing in new cigarette factories is very low because there is no need for additional cigarette production. So over the past five years, Altria has paid out all the cash it generated to shareholders in the form of dividends and share buybacks, which amounted to more than $4 billion a year. Altria's track record of consistently giving cash back to shareholders demonstrates that it can generate healthy levels of cash and that it allocates capital in a disciplined way – these are qualities we like to see in a company. Shareholders have been rewarded handsomely for owning Altria – total return over last five years has been more than 180%.

Notes:

(1) Free cash flow is cash generated from operations less investments

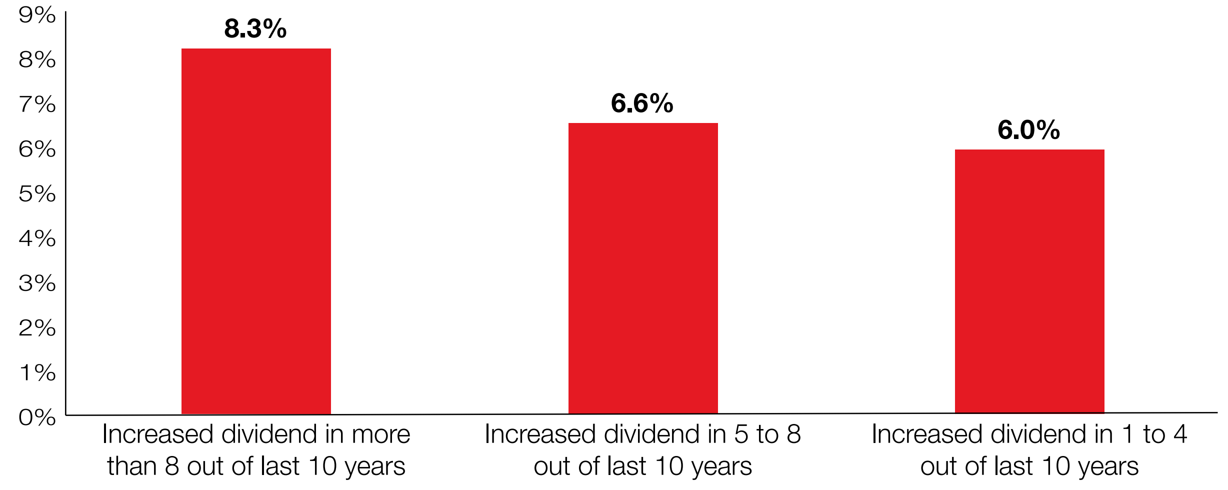
On the other hand, look at a company like Tesco (the UK's largest supermarket chain) which cut its dividend by 75% in August 2014 and stopped paying dividends altogether in January 2015. The dividend cut came in the wake of structural changes in the UK supermarket business. The majority of Tesco stores are large out-of-town stores, which are seeing a decline in customer traffic. Instead, consumers are shopping more frequently in convenience stores located closer to their homes and are also increasingly doing their grocery shopping online where Tesco faces competition not just from supermarket peers but also from online-only grocers like Ocado. Discount supermarkets like Aldi and Lidl are also luring customers away from mainstream supermarkets like Tesco. This confluence of factors has led to lower profitability at Tesco. The issue is exacerbated by the £13 billion in debt they have on their balance sheet, which they took to expand overseas, open new stores and invest in non-core activities like garden centres, coffee shops and restaurants. Several of these investments have yielded losses or poor returns and Tesco has had to sell them. Weak supermarket business combined with a high level of debt led Tesco to cut dividends in order to preserve cash.

Dividend cuts indicate two things here. Firstly, Tesco is not able to consistently generate good cash flow from its operations because increased competition in supermarkets and changing consumer habits mean profit levels are likely to be lower for at least several years. Secondly, either Tesco management didn't have the awareness that reinvestment opportunities available to them were not attractive or they didn't have the discipline to not invest in them despite being aware of the poor returns. For example, the UK was already saturated with supermarkets and any incremental store that Tesco opened would have earned a low return on investment but despite that, Tesco kept opening new stores. In simple terms, if return on investment on a second Tesco store in a town was likely to be lower than the first one and below a threshold attractiveness level, then the shareholders would have been better off if the cash used to open the second store had been returned to them instead. Tesco's inability to consistently pay dividends is a clear indicator of their management's inability to compete effectively and to appropriately allocate capital. Shareholders have had to pay the price for owning Tesco – they have lost more than 40% of their investment over the last five years.

Another example is Seadrill (a Norwegian offshore oil and gas driller in a highly cyclical industry), which has had a very irregular pattern of cash return to shareholders. Although it paid out more than US$1 billion in dividends each year from 2011 to 2014, it didn't pay out any dividend in 2015 as a result of the oil market downturn. Cutting dividends in a cyclical downturn is the right decision and that in itself doesn't make Seadrill a bad company. However, the business currently has US$13 billion of debt, close to eight times its 2015 operating profit of US$1.6 billion, and has been in negotiations with its lenders to restructure its debt. The dividend cut implies that capital allocation is a cause for concern. Seadrill shouldn't have paid such a large dividend in good years given the large amount of its debt and cyclical nature of its business. It should have had the discipline to preserve cash and pay down debt, something that could have prevented the current debt restructuring. It is not surprising that Seadrill's shareholders have lost more than 90% of their investment in the last 5 years.

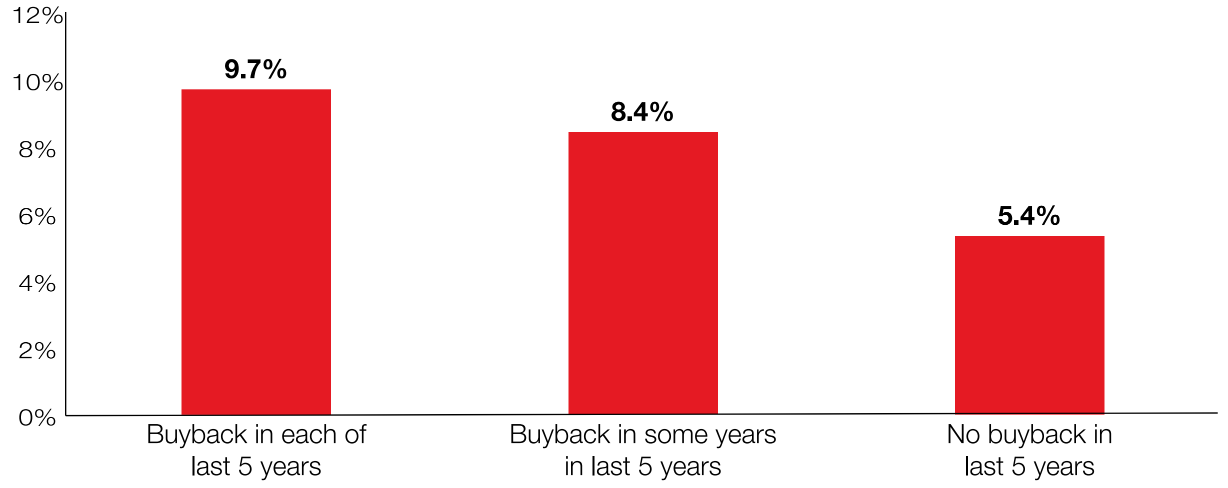
Our empirical analysis supports our preference for companies that consistently return cash to shareholders. As you can see in the charts below, companies that regularly increased their dividend generated better total shareholder returns and companies that consistently bought back shares outperformed the ones that didn't. Of course if a company has plenty of opportunities to reinvest at attractive rates of return then we would prefer them to do that, but many, if not most, companies do not have sufficient attractive reinvestment opportunities. In this situation returning the cash to shareholders is clearly the preferable thing to do. We have seen through the examples above that consistency in cash returns is a sign of a good quality business and vice versa and this is why we highlight it in our investment philosophy.

Chart 1:
Annualised total shareholder return of companies that pay dividends (Jan 2006 – Sep 2016)



Source: NAM UK

Chart 2:
Annualised total shareholder return (Jan 2006 – Sep 2016)



Source: NAM UK

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