NOMURA ASSET MANAGEMENT U.K. LTD.

Nomura's Global Equity Team on Skilled Management

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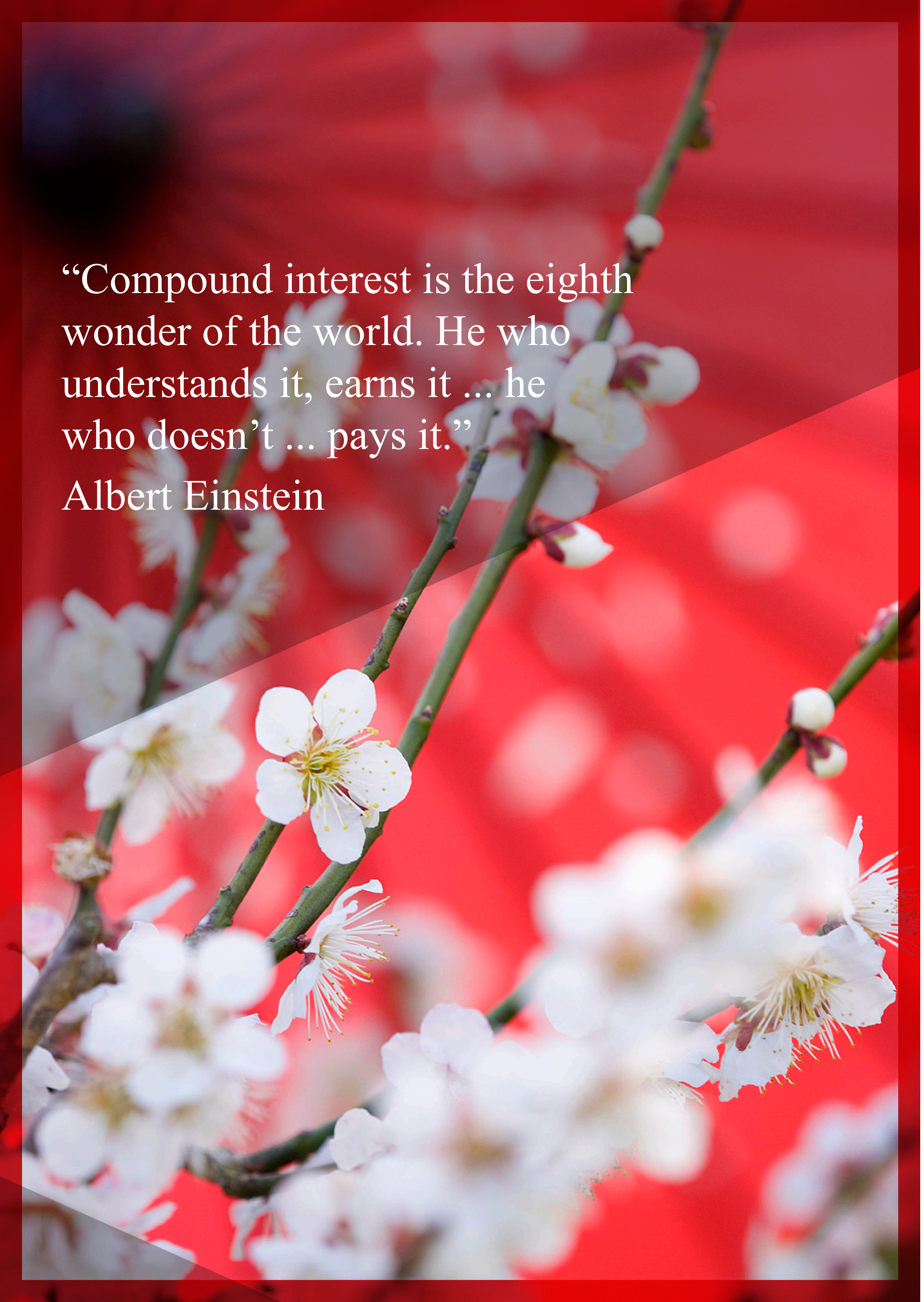

Skilled Management

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 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 skilled management.

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.***

What does skilled management mean for us?

There are two basic components:

Firstly and most obviously they need to run their operations in an efficient way;

But secondly and often more importantly for the long term investor, they need to efficiently allocate company capital. Efficient capital allocation allows investors to benefit from the positive long term effects of compounding.

We've picked out a couple of examples to illustrate our view of skillful capital allocation.

Richard Cousins at Compass Group

Richard Cousins started his career at Cadbury-Schweppes in 1981, and then learned about capital allocation at BPB plc, the world's largest manufacturer of plasterboard, back in 1990. He was appointed BPB plc CEO in 2000, taking the company into the FTSE 100, increasing its market capitalization from £1bn to nearly £4bn and finally selling the business to Saint-Gobain for £3.9bn in December 2005, after a hostile takeover. He maximised shareholder value.

Cousins was appointed CEO of Compass Group in June 2006, joining a company which had over-expanded into 98 countries and lost its direction after too many acquisitions and taking on too many low margin contracts. He decided to simplify the business. In the food services industry you need scale to achieve a reasonable margin, so he decided to halve the number of countries the business operated in and he sold all non-core operations in 2006 and 2007.

Food remains a core competence for Compass Group and management takes a cautious and incremental approach to support services. This wasn't always the case and back in 2010-2012 Cousins became overly focused on support services and exploring large acquisition opportunities. From 2012 he signalled a more cautious approach based on organic growth and also returned £1bn to shareholders through a special dividend in mid-2014.

Organic growth has always been a priority for Compass Group, but they have a rate of return hurdle needed to justify investments in internal projects. When Cousins was appointed CEO in 2006, the expansion plan of Compass Group was already complete, so he decided to reduce capex and take time to build capabilities as well as seeking attractive reinvestment opportunities.

Capex is an excellent use of capital for Compass Group because the returns on capital are high and it has driven strong organic growth, outperforming competitors in the key markets of the US and the UK. In North America Compass Group's capex is around 3% of sales, there are plentiful investment opportunities and Compass Group is achieving a Return on Invested Capital (ROIC) of around 28%. Outside of North America ROIC is lower at around 20%, so Cousins has rationally limited the capex to just 1.5% of sales. European capex was below 2% of sales in 2012-13 when they needed to restructure and improve the efficiency of the business, but now returns on capital are higher (around 24%) so investing more capital makes sense – capex to sales has been increased to 2.5%.

Cousins' **acquisition policy** is reminiscent of Warren Buffett's approach of integrating great businesses within the Berkshire Hathaway platform. He has always been more focused on finding companies that bring expertise in a certain sector or sub-sector, a good client portfolio and great management teams with even greater leadership that could actually grow the business. He has historically avoided acquisitions that just bring volume and has typically kept the acquired companies with strong brand names, people and culture. For example Levy Restaurants was acquired in 2001 and is the current market leader in the US sports and leisure market with $1.3bn in sales in 2015.

Also similar to Berkshire Hathaway's approach, Cousins runs a decentralized organization, which he believes has been positive for Compass Group. We share his view, as it allows the company to align its operations very closely to clients and create bespoke product offerings in different segments of the market.

Finally, **share buy-backs**, which were uncommon for Compass Group prior to his leadership, have been used by Cousins as an opportunity to create value for shareholders. He will buy back Compass Group stock at the right price.

As a result of this, Compass Group return on invested capital (ROIC) has improved dramatically from around 9% in 2006 to around 19% in 2015, reflecting the exit from non-core assets and geographies, more capital discipline and rapidly improving margins; as a consequence Compass Group's shareholders have done extremely well. The total return on Compass Group shares over the past 10 years is 2.3x that of the S&P500 and over 4x that of the FTSE100.

Kasper Rorsted at Henkel

When Kasper Rorsted became CEO of Henkel in 2008 the 132 year-old German company was still controlled by the Henkel family and had a leading adhesives business, a laundry business focused around the Persil brand in Europe and a personal care business, with well-known brands such as Schwarzkopf hair colourant. Sales growth was pretty decent at around 4% and dividends had grown at 7% over the past five years. Although margins were below peers, Henkel still generated a Return on Invested Capital of about 10%. In short, things were comfortable and Henkel was probably quite a pleasant place to work. This was epitomised by the company's slogan of “A Brand Like a Friend”. However, Rorsted was of the view that things were too comfortable at Henkel. He immediately changed the corporate slogan to “Excellence is our Passion”. Rorsted also instituted an employee management scheme that involved forced ranking of individuals as top, strong, moderate or low performers with significant implications for bonuses. Over the next five years, Rorsted would change over half of the top management at Henkel. In short, Rorsted clearly felt that too much of the company's ‘value’ was accruing to underperforming employees.

In November 2008, Rorsted laid out his 2012 targets for average sales growth of 3-5%, operating profit margin of 14% and at least 10% earnings per share (EPS) growth. At the time, investors were rather sceptical of these targets. Rorsted then set about making Henkel a much more efficient business. The employee count declined 10% over the next five years with sales per employee increasing by over 40%. The number of suppliers was reduced by nearly 60% and 60 manufacturing plants were closed. Rorsted also consolidated purchasing, finance and HR functions into shared service centres.

The financial impact of these changes was dramatic. In the space of five years, Henkel closed the margin gap versus its peers across its Adhesives, Home Care and Personal businesses. Group margin increased from 10% to 15%, cash generation dramatically improved and dividend growth doubled to 15%. Return on Invested Capital also improved to a level in the mid-teens, having previously been just above the company's cost of capital.

Shareholders were handsomely rewarded for Rorsted's actions. Book value grew at a compound rate of 7% but the share price grew at a compound annual rate of 15%. Henkel's share price rose 230% during his tenure versus an average of 110% for its peers. Rorsted had successfully ensured that shareholders received their fair share of the value generated from Henkel's brands and operations. Despite making Henkel a much leaner business, this had no negative impact on customers. In fact, Henkel was one of the few fast-moving consumer goods (FMCG) companies to gain market share across its categories during the period, despite increasing competition from private labels.

Rorsted's value as a manager was evident when it was announced that he would leave Henkel and become CEO of Adidas in January 2016. Adidas share price increased by 6% on the day. Although we think Rorsted did a good job with Henkel the positive impact of Rorsted on the company has been fully reflected in the share price meaning that the “Discount Valuation” component of our investment philosophy is not met (at the time of writing).

We do believe that the senior management of even very large companies can have a material impact on the performance of the companies they manage and hence the creation of value for company stakeholders. Of course efficient operations are important, but to benefit from the “eighth wonder of the world”, compound interest, skilled capital allocation is critical.

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