DELIVERING SHAREHOLDER VALUE

First of all let me give you the good news. I've been allocated 45 minutes but I'm sure I won't take that long - so the drinks session could be closer than you had feared.

Next, let me say, quite genuinely, that I'm very flattered to have been asked to address this meeting on Delivering Shareholder Value.

My fellow speakers come mostly from huge organisations whilst Halma, the Group of which I have been Chairman since 1973, is - I like to feel - still a relatively small group with a market capitalisation of about half a billion pounds

In contrast, the U.K. market capitalisation of Hong King and Shanghai Bank is £56 billion, Lloyds and T.S.B. is £40 billion, British Gas and Centrica is £14 billion, Guinness is £11 billion and Boots is £7 billion.

However, before I sink totally away in a sea of modesty, let me claim that Halma's own track record is a remarkable one. Since that is the qualification for me being here today, let me address that point first.

Datastream reports figures of earnings per share growth for all quoted companies over the latest 20-year period. The most up-to-date figures when I prepared this talk were for the 20 years to mid August 1997.

Using e.p.s. as a measure of company performance has its critics. Certainly no single measure of this kind is perfect. But e.p.s. is still a pretty good indicator, over a sufficiently long period of time, of a group's performance in delivering shareholder value.

The first slide deals with some of the major public companies represented on the platform at this conference. The data for British Gas and for Lloyds T.S.B. does not cover the whole 20-year period and so I have included the figures for one of the other large U.K. clearing banks. It is not part of my objective to identify the performance of each individual company and therefore in no particular order the coloured lines represent the increases achieved by Boots, Guinness and H.S.B.C. and the other clearing bank. Because Datastream only give opening and closing numbers, the curves have had to be drawn as if growth was constant year by year.

The yellow line shows the equivalent percentage increase in the Retail Price Index over that period.

You will see that over the 20-year period the R.P.I. increased by 240% and the company increases ranged from 200% to 600%.

All excellent performances but it does help to put them in perspective if we now look at slide two. For obvious reasons, this has to be on a different scale, but the yellow R.P.I. line has been drawn in again on this new scale.

The next graph (slide three) shows the R.P.I. and also the best performing company from slide one.

The next graph (four) adds the performance by Marks & Spencer which increased its earnings per share by one thousand three hundred per cent.

The next graph (five) adds Tomkins which increased by two thousand eight hundred per cent.

Only two companies in the Footsie 100 beat Tomkins over the period. They were Glaxo (slide six) and Rentokil (slide seven).

If we then extend the analysis to include the next 250 companies by size, only four companies were better than Rentokil, and one of those companies was Halma (slide eight). Only two companies were ahead of Halma (marginally) and Halma's score over the whole 20-year period represented an average compound increase in earnings per share of 22.5% per annum. Just before anyone raises the point, I should also confirm that the base year 1977 was itself a record year for Halma with an increase of 328% over the previous year.

This suggests that at least we've been getting some things right. The next question though is how relevant is our experience to this particular conference? Clearly, creating shareholder value from a tiny base as we did at Halma is very different from building it if you have to start with a group which is itself already massive or if your own organisation seems very different in nature.

Despite this, I do believe there are some general lessons which can be gleaned from our experience.

Before exploring these, I would like to make two points. The first is perhaps obvious but I would still like to mention it. The heading I've been given for my talk today is 'Halma - Relying on traditional methods to deliver shareholder value'. The words are the conference organisers', not mine.

Let me refute any unintended implication that our methodology within Halma is either conventional or derivative. Like any other very successful company, we can identify strong elements of individuality, even uniqueness in our individual approach to business and I hope that some of this emerges from my talk.

The second point, whilst also perhaps obvious, is more fundemental. In preparing this talk, I was struck again and again by the differences between the short-term and the long-term approach to building shareholder value.

This is a very conventional comment when applied to investors and financial institutions. How often have we heard debates about the City's so-called 'short-termism'.

It is less conventional as a comment when applied to the management of a trading business. Nevertheless, I believe that there are fundamental differences between selecting a short-term route and a long-term route.

There tends to exist a tacit assumption that these are closely related, that a successful short-term exercise in increasing shareholder value inevitably is a step towards a long-term increase in value.

In instance after instance I found myself having to observe that this was not the inevitable case. That often the two routes point in totally opposite directions and a specific choice needs to be made between them.

A number of examples of this emerge later in my exposition but just to drive the point home, let me take just one 'Mickey Mouse' scenario.

Imagine you either as an investor or as a public company chairman owned Microsoft with a p.e. of 40. In theory you could sell part of Microsoft and use the proceeds to buy a company we can call British Metal Bashing Limited with a p.e. of 12. The arithmetical outcome would be a huge increase in your earnings per share.

You have certainly enhanced shareholder value in the short term but have you got a better company? Could you just bear that example in mind because I come back to it later in my talk.

At this stage I am just using it to illustrate that there can be a dichotomy between short- and long-term strategies. Short-term can end up saying 'sell Microsoft'. Long-term says 'keep it'. That's the Warren Buffet approach.

Nor am I suggesting that long-termism is the only route. Short-termism is a perfectly valid alternative. It must be because it is obviously the route followed by many companies and many institutions.

What I am saying is that there is often a fundmental difference in strategy and in tactics between the two routes. The key thing is to decide where you are - which route is being followed.

This is self-evident if you are an institutional investor. But it is an equally important decision if you are the chief executive of a group. How do you see yourself creating shareholder value? Are you aiming for short-term, transaction-related value creation or for long-term, building-related value creation? Both approaches are valid, both can be spectacularly successful but they are very different.

It won't surprise you to learn that at Halma we chose the long-term view, aiming from the start to build slowly and carefully, very much with an eye to the future. Obviously this is the approach which will be the theme of my talk today.

Following this long-term route requires long-term vision and targeting. It entails quite a lot of detailed planning. It is a purposeful and systematic exercise which should lead to a set of very specific and relatively fixed objectives. And I mean 'fixed'. If these fixed objectives don't exist then you can all too easily be blown off course by opportunistic arguments. Again, it sounds an obvious point but it is interesting to contrast the vision and steady purpose of

companies such as Marks & Spencer as against the twists and turns and changes of methods adopted by some other groups.

It also seems self-evident to me that lying behind such a vision has to be a sound mathematical/financial model. This should cover a decent period ahead, maybe five years, and it should set out very clearly the logic and the arithmetic of how you actually plan to get from Point 'A' to Point 'B'.

It continually surprises me how little this aspect is explored at meetings with institutions and potential investors. In 25 years' experience of meeting institutions and analysts, I have rarely been questioned on this topic. Questions tend to focus on past results and perhaps just a little on short-term prospects, maybe one year ahead. Rarely do they look at the underlying financial arithmetic which should underpin longer-term company plans. And yet I see this as absolutely crucial to building shareholder value, if indeed those institutions are themselves seeking to create long-term value.

At this point we have to take a little trip down memory lane. Halma's own long-term planning and its financial modelling were radically shaped by our having to live through the events of the mid-1970s. I know that to many people here today that must almost count as pre-history.

There was a kind of economic blizzard which lasted about four years from 1973 to 1977. The Stock Market was in shock. We were producing a string of sensationally good results at Halma but at one stage our p.e. ratio was less than four. Inflation was running at 17% per annum and the banks couldn't or didn't want to lend money.

(Post-tax earnings to March 1977 = £286,600. Market capitalisation 4,721,545 shares x June mid share price of 22.5p = £1.06m.)

Against that background we deliberately chose to develop a group which would be completely self-financing but which would also be able to sustain a growth in e.p.s. in the range of 20%-30% compound per annum or, as we later defined it, 15% plus inflation. This latter target was our overriding corporate objective.

We determined that in order to achieve this in that very inflationary climate, we needed to be achieving an average Return on Capital Employed of 40%.

Was it a good idea at the time? Without doubt the establishment of these very demanding targets was a key driver in achieving the results we did.

Is it still a good idea in 1997? I can tell you that once you have created and find yourself running a group with such a high rate return on capital, it is a position you will relinquish only with extreme reluctance!

How did we go about achieving these targets?

Clearly they represented enormously ambitious goals. A point to stress is that at the time we constructed the model, the real-life Group we had was miles short of achieving it. To many

people, our targets would certainly have looked unattainable and I will return to that point in a moment.

It's self-evident that the sequence in achieving long-term growth in shareholder value is:

First to establish the mathematical model which meets your needs.

Then, steadily and systematically to change the group until it gradually comes to conform with your model. I come back to this point later.

Although the financial model might involve very detailed arithmetic, the salient points arising from it must be simple and easily understood. It is enormously helpful if top management can keep the main features and objectives always in their minds. Then any detailed or tactical issue which emerges can be judged simply and quickly on the basis of whether it helps or hinders you in achieving your targets.

If the targets are too complex then this quick mental reference can be very difficult to achieve. One can easily see that this is a difficulty which bedevils any large organisation. An extreme example is central government where almost every decision has a positive impact on one major objective but has a negative impact on some other major objective.

This need for clarity and simplicity does make me nervous about some of the more sophisticated measures, including some covered at this conference. It is very easy to get

bogged down by acronyms. When someone say E.V. to you, does he mean economic value or does he mean enterprise value, and so on and so on.

Last year I was invited to a session where selected and very successful public companies were being praised for their success in scoring well against certain acronyms. It was all very flattering and we already knew we had done very well but it was quickly apparent that none of the senior people there, myself included, the world experts on the companies they controlled, could relate their own known performances to the actual scores calculated under the acroynms.

There is tremendous virtue in having relatively simply, relatively understandable key targets. The overriding target we selected for Halma was to increase earnings per share at an exceptional rate. Every associated target or action stemmed from this and every detailed action - cost reductions, R & D expenditure, capital investment and so on - could be seen to relate to this basic overriding target.

I said a few moments ago that I would come back to the point about 'What if the desired targets simply look unattainable?' People might think the targets look crazy against the background of what is regarded as possible or realistic in your own particular industry or activity.

When we set the Halma target as 40% Return on Capital, the Group's actual return on capital was only 20%. That was already a great deal better than the then average in the engineering industry. So the target is unattainable. What do you do?

There are two fundamentally different ways of tackling a major shortfall like this. One long term, the other short term.

The route we adopted at Halma as long-term operators was to focus on mix. In broad terms, simply doing less of anything that gave returns below the target level and doing more of what gave returns above this level. It sounds simplistic but given time, the cumulative effect of this can be massive, even in a large group. It does take time but it has the enormous virtue that it is virtually risk-free.

The analogy I have often used with analysts in discussing Halma is that it is like a centipede with very many little legs, but each leg moving a tiny step in the right direction. If every small move is positive and if every negative move is eliminated, then it is surprising how quickly one can move towards a defined objective. That is the long-term route.

The alternative and short-term route of course is to restructure the Group in a strategic way, probably through diversification based on acquisition. This can obviously be done. It has been done successfully many times, it can have dramatic results, but it is essentially a high-risk strategy.

This brings us neatly to the subject of growth by acquisition. The Halma Group is perceived as one which has grown by acquisition and has an unusually successful acquisition record. What lies behind this?

We need first to agree on some definitions. I see a fundamental difference between acquisitions funded by share issue and those funded by internal funds.

At the very outset with Halma we decided that since our overriding objective was to increase earnings per share, our best policy was not to issue any more shares. That sounds crazy to many people. The conventional view and the road most people choose towards success is to establish a high rating for their shares and then issue them.

Again, this illustrates the difference between the short-term and the long-term approach. The short-term manager, once he has achieved highly rated shares, logically sets out to issue as many as possible, seeing this as a source of cheap money or else a means of acquiring companies he could not otherwise afford.

The long-term manager, equally logically, perceives that he is (or else hopes he soon will be) managing an unusually successful company; one which, for example, is making 40% return on capital employed and is growing consistently. All common sense says that if you are fortunate enough to own such a company then don't sell it. If that logic is true, it is equally true not to issue further shares. Why share the ownership of this gain with anyone else?

This is exactly where we stand with Halma. We don't like issuing our shares and over the past 25 years have issued very few - only equivalent to about 2% of our share capital per annun.
All the rest of our growth and our acquisitions have been financed by our own self-generated cash flow. This means that all the profit increase has fed through pro-rata into increases in earnings per share - to the direct benefit of our shareholders

Many people, including most public companies, operate on the basis that acquisitions will create wealth for shareholders. Self-evidently, this is the general view because self-evidently that is what everyone does. Management identify acquisition targets and institutions and the media encourage this activity either actively or passively.

Meanwhile, a large body of academic opinion argue that acquisitions generally serve to reduce shareholder value. Where does the truth lie?

My own view is that it all depends on definition.

There is a tendency to use a simple envelope word like acquisition when what exists is a whole range of activities differing from each other very markedly and yet described as acquisitions.

This is a self-evident point but is there any mileage in recogising these divergencies and in trying to group acquisitions into those which are more likely to fail and those which are more likely to succeed?

I would suggest that the first distinction to draw is between acquisitions which are funded by internally generated surplus cash and those which are funded by share issues.

As I said earlier, in Halma, because of our high rate of return on capital, we have been able to fund almost all our acquisitions from surplus cash. Once you have surplus cash then the

deployment of it, for interest earning, for capital expenditure, for share buy-backs or for cash acquisitions, is essentially a matter of tactics.

Because we have funded acquisitions this way, the vast proportion of the wealth created within Halma has in fact come from organic growth. Ignoring scrip issues, our total shares in issue over the 24 years from 1973 to 1997 increased by only 46%. Over that same period, our pre-tax profit increased by 22,000%.

So the first distinction I would draw is that growth by internally funded cash is more akin to organic growth than it is to growth by acquisition.

Nonetheless, it is clearly true that even if we define the outcome as 'organic growth' it is still true that over the years we have acquired many businesses from outside the Group. Whether these are purchased for cash or for shares, they are all subject to one feature - acquisitions are risky.

So let's see if we can examine this concept of risk and see if it is possible in general terms to categorise acquisitions also in terms of their inherent risk.

Dating from my own very first efforts in acquisition work, back in the very early 1970s, it always seemed self-evident that if you buy a business from a private owner, he is probably the world's expert about the business he owns and he won't sell to you unless he thinks he is getting the best end of the deal. Similarly, if you buy a public company you have to start from the concept that the Stock Exchange is a perfect market but you are then choosing to buy a

company at a premium of say 30% to 40% over what has until then been perceived as the correct price.

The inference is that your risk is highest when your knowledge is least and when the vendor's knowledge is greatest. The reverse must also be the case.

The obvious conclusion is that the risk in acquisitions can be hugely reduced if you are already highly expert in the field. In Halma it has always been our policy to operate at this end of the spectrum where the risk is least. That is to say where we are already expert in the business which we are buying. If you buy a business which is a replica of one you already own and manage successfully, then you are in a good position to check whether or not you have a good deal. Having gone back to check our own figures, I find that this was the case for 70% of the individual businesses we have bought over the past 15 years. Where we do move into a newish field, we do so very cautiously and, wherever we can, we will buy small so as to reduce the scale of the risk.

The opposite is also true. The less knowledge you have of the target company's market or product area, the higher your risk. By definition, therefore, the highest risk acquisitions are those which lead to diversification.

In theory, the 'conglomerate type' acquisitions aim to offset this risk by their well publicised re-organisational and cost-cutting skills. Personally, I am profoundly cynical about this. Whilst you can always cut costs, my observation is that the path of creating a good company out of a bad one is a painful and a very long-term exercise, not always successful. If, because

of your lack of detailed knowledge you have already paid too much or else bought the wrong company, the cards have got to be stacked heavily against you.

This general point has been well recognised in the market over the past four or five years and it is a sign of the times that the buzz word now is 'bolt-on acquisitions'. Conglomerate type acquisitions are out and 'bolt-ons' are in.

But what is the definition of a 'bolt-on'? It is used very loosely and there is no generally agreed definition.

I would like to suggest to you that the true bolt-on acquisition is one which when purchased can then be readily integrated into an existing Group company. Over the years in Halma we have made many such acquisitions and they have predominantly proved successful.

There is then logically another category: the 'quasi-bolt-on' which I would define as a stand-alone company which meets the same definition, that is to say that the purchaser is already expert in this particular product range but where the company purchased happens to be big enough to stand alone.

The next thought I would like to suggest is that in any acquisition there is a quality aspect to be examined, as well as a quantity aspect.

I believe that most 'hands-on' management will recognise that there is a wide difference in the quality of the earnings you can buy but this aspect is often not given sufficient weight by financial advisors.

Some advisors tend to focus on the arithmetic of your group, maybe its lack of gearing or its highly rated paper, and point out that acquisition of such and such a company would be a good move. For example, it would increase earnings per share. I gave an example earlier of the fallacy that sometimes lies within this argument. The stark contrast between selling a slice of Microsoft and using it to buy British Metal Bashing Limited, for example.

I can give another angle on this through our experience at Halma.

One of the features of the arithmetical model which I mentioned earlier was the target of achieving a high return on capital employed. Although it took us about five years to get there, we have never fallen below this 40% level for the past 14 years. What we found was that once we had achieved and were enjoying this situation, we then became extremely reluctant to relinquish it.

Consequently, it became important that every new company joining us could also achieve this performance. If not, then our wish not to dilute our hard won position meant that we did not want it in the Group.

The general lesson I would suggest is that in looking at an acquisition 'quality' has to be a key issue. There will be many ways of defining it, depending on your own circumstances, but it is

ignored at your peril. For the longer-term operator, quality of earnings is paramount and there is no p.e. ratio high enough to compensate for or to allow for this. It's an old saying but a true one that you can never pay enough for a good acquisition and never pay too little for a bad one.

So, having covered some of the ground on acquisitions, let's turn back to the overall question of whether acquisitions are going to create or destroy shareholder value.

They can obviously do either. My observation is that they have the best chance of creating value where the business purchased as nearly as possible meets the following criteria:-

- It is paid for by internally generated cash.
- It is a replica of one already owned by the purchaser.
- It is a bolt-on or quasi-bolt-on as I just defined these terms.
- And, finally, it is likely to improve the quality as well as the quantity of earnings.

This is essentially the route we have followed in Halma.

By definition, therefore, the reverse applies and the acquisition least likely to succeed is the one which is only viable if paid for in shares, is a diversification, is large in relation to the company that is buying it and is identifiable as a turn-round or relatively poorly managed business.

The second theme for me this afternoon is 'building leadership in niche markets' and although this sounds a rather narrow theme, it does touch on one or two other aspects of creating shareholder value.

First of all let me tackle definitions again and define what I mean by a niche market. This is another phrase and concept often very loosely used. If it is to have any real meaning it has to imply that the niche operator has major influence or dominance over his market. This is simply not possible if you are small in relation to the market or if you have too many competitors.

I believe that for practical purposes you cannot say you are in a niche market if you have more than 10 competitors in your home market and more than 80 competitors worldwide.

If you are in a niche market within this definition and you are already a dominant player, your position then either looks very good or very bad according to how you perceive it.

The short-term operator immediately sees that he has very little to work on except cost reductions. He sees that he already has 60%-70% of the market. This means to him that the market is saturated and that he has nowhere to go. A real niche market is going to be unattractive to most short-term operators.

The long-term manager, however, can see it very differently. He will focus on the attractive features and these will be high margins and high profits. He will observe that if he can only

figure some way in he can increase the size of the whole market, he can also increase the size of this already very profitable business.

What differentiates the niche market operator from the conventional management approach is that he focuses his efforts on growing the market as a whole and not on vying with his competitors. It is very different from the skills deployed by most companies who tend to operate with the concept of a relatively fixed market size and therefore have a strategy based on increasing their market share. The approach which is suited to niche market operating is an area in which Halma as a group has become very experienced and skilled over the years.

Whilst my next point has some obvious relevance to niche markets, I would prefer to treat it as a general theme.

Larger companies, especially the more traditional ones, see their route to success coming from cost reductions. Typically, they will see as a five-year goal the need to make such and such a reduction in numbers employed or in labour spend.

At Halma, maybe because of our size, maybe because of internal culture, we see ourselves as an 'added value' company. Product design and development is a major issue. Whilst that often does, and must, have the effect of reducing labour or material cost, the key drive is to create value or novelty for our customers. In this way we see ourselves as very actively trying to maintain or even widen the gap between prime cost and final selling price.

One of the most telling examples to demonstrate at least part of this concept was in John Harvey-Jones T.V. series some years ago when he went to a Stoke-on-Trent pottery and found the management were obsessed by getting cost reductions so they could sell their plain plates at the competitor's price of 10 pence each. He took some blinkers off their eyes by pointing out that if they employed better designers and just printed something different on to the plates, they could multiply the price they charged and get maybe 40 pence each.

Looking quickly at my watch, the final topic I've been given today is, 'Is there any benefit in using value and performance metrics?'

That's an easy one. The answer is 'Yes'.

I suppose I should say a bit more!

First of all, let me give you an anecdote:

Last year I came back from an award ceremony where the winners amongst the top 500 quoted companies were those which had the best V.C.Q. and M.V.A. performance (Value Creation Quotient). Arriving back at my office literally on the very same day I picked up the current edition of 'Business Age' where the lead article identified and named 'Britain's Best Managers' but chose to use E.V.A. as the measure (Economic Value Added). Both very sophisticated measures of management performance. I was immediately interested to see if the same companies came near the top in both lists. It was unnerving to find that the top 20 on each list only included three companies who appeared in both (Halma was one!). The top company by

E.V.A. performance was ranked 223rd when applying V.C.Q. and the sixth ranked company by V.C.Q. performance was rated 224th on the E.V.A. list.

The point of that anecdote isn't to end the day on a depressing note - I hope - but to underline the fact that all of these measurements have to be seen in context.

Another example was the press comment a couple of weeks ago encouring the utilities to 'add value' to their businesses by borrowing money and using the borrowings to buy back shares.

There is no doubt that arithmetically these transactions can have this effect in that they increase the number which has been defined as value. However, that is not necessarily the same as actually adding value. As a simple practitioner in this area I have to question whether a company has necessarily increased its real value by becoming more heavily borrowed. Maybe in a short-term sense yes, but in a longer-term sense no.

I'd like to come back to the earlier example of whether Microsoft added value to itself by taking over British Metal Bashing. In that case the arithmetic works equally impeccably in increasing the earnings per share. What the market does is to look at the transaction in terms of perceived quality. If it feels that Microsoft has diminished its average quality then it adjusts for that by reducing the p.e. ratio.

Similarly, it makes sense that the market will look at transactions like the utilities' share buy-backs to see whether the p.e. needs to be adjusted because of a change in perceived quality. The jury is perhaps still out on that one.

My final comments therefore on measurement techniques are:

1. I believe there is no one universal measure which can or should supersede the others.

2. They all have some fault or problem which means you have to use more than one and then make an overall judgement on all the data.

3. They all tend to suffer from the fact that they are based only on published information - with all the limitations which that implies.

4. Be suspicious of any measurement system which is so complex or difficult to apply that you need to use a consultant.

5. Don't use these measurements in isolation as a means to decide specific management action - certainly don't take action from them if that action seems contrary to plain common sense.

DSB/ECB/9th October 1997