The 2016 Australian Value Creators Report

Shareholder Value Creation Through Persistent Uncertainty

Analysis of ASX 200 Company Performance

The Boston Consulting Group

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PREFACE

Since it was founded in 1963, The Boston Consulting Group (BCG) has focused on helping clients create competitive advantage. Each year, our global *Value Creators Report* series analyses the world's top performing companies to build an understanding of what drives the performance of leading players across all industries. In the *Australian Value Creators Report*, we look at how our economy and market are performing relative to global peers, how different sectors are performing within Australia, and which companies are creating the most value.

So, what makes some companies more successful at creating value than others? Which sectors have sustained strong performance? And what role can shareholders play in the value creation agenda?

EXECUTIVE SUMMARY

In 2016, Australia's largest listed companies once again demonstrated that shareholder value can be created across all sectors, regardless of broader macroeconomic trends. Well-managed companies were able to stand out from the crowd and deliver a strong year of returns for shareholders.

Uncertainty remained a pervasive theme across the globe in 2016, a year characterised by political upheaval. In Australia, this theme of uncertainty was reflected in the first quarter of negative growth since March 2011. Inflation and the Reserve Bank of Australia (**RBA**) cash rate continued to fall, with both measures reaching historic lows in late 2016.

Despite this broader climate, companies in the Australian market still managed to perform strongly. The S&P/ASX 200 (**ASX 200**)[1] index rebounded from negative returns in 2015 to deliver a one-year Total Shareholder Return (**TSR**) of 13.2% in 2016. The ASX 200's five-year TSR performance also improved on 2015, with a return of 11.2% per year, although it still lags the United States (**US**) (16.4%), Japan (13.7%), and Europe (12.2%). The ASX 200's five-year TSR performance was primarily delivered by profit growth.

Among the five largest sectors of the ASX 200, Healthcare continued to be the strongest in 2016, in terms of both one-year (25.5%) and five-year (26.1%) TSR. Mining/Materials made a robust recovery, with a one-year TSR of 22.6%, despite five-year negative total returns. Industrials delivered a strong one-year TSR of 17.5% and a five-year return of 15.0% per year. Financials and Consumer Staples lagged the broader market, underperforming the one-year TSR for the ASX 200 index.

Top-quartile performance on the ASX 200[2] in 2016 required a five-year TSR of 26.2% per year. At least one company from each of the 11 sectors in the index met this threshold, the highest since 2009. In 2016, the median five-year TSR performance of the ASX 200 was

16.8% per year, meaning that top-quartile companies outperformed the market by at least 9.4% per year.

Delivering consistent excess returns to the market is always a challenge. In Australia, activist investors – shareholders who take a proactive approach to value creation – are increasingly seeking to engage and collaborate with management to unlock value within the organisations they invest in.

We have identified six levers that activist investors frequently use to deliver value, ranging from short-term portfolio strategy initiatives to longer-term governance and business performance agendas. Increasingly, these investors are breaking away from the classic agitator mould and adopting a more collaborative approach to drive long-term, sustainable value.

We also see opportunities for proactive management teams to use these levers to take an outside-in, or "do-it-yourself" approach as they seek to drive long-term shareholder value.

NOTES
The analysis in this report uses a cut-off date of 30 September 2016, unless noted otherwise. Economic indicators are based on calendar years and company financials from public announcements use Australian financial years, unless noted otherwise.

Where we refer to a country's TSR throughout this report, we refer to the performance of the following indices:

- Australia = ASX 200
- US = S&P 500
- Japan = S&P TOPIX
- Europe = S&P EUR
- Emerging Markets = S&P Emerging LargeMidCap

All TSRs are calculated based on Total Gross Return.

1. The S&P/ASX 200 Index is recognised as the investable benchmark for the Australian equity market, as it addresses the needs of investment managers to benchmark against a portfolio characterised by sufficient size and liquidity. It is comprised of 200 stocks selected by the S&P Australian Index Committee. It is a capitalisation index, meaning that it represents the sum of the market capitalisations of the companies making up the index. Changes in the value of the index reflect changes in the aggregate capitalisation of index constituents as their share prices change. The weight assigned to each company in the index is proportional to that company's capitalisation. It is also an accumulation index, which assumes that dividends are reinvested, and measures both growth and dividend income

2. Among companies that had been listed for at least five years. This included 160 companies in 2016

AUSTRALIAN MARKETS RECOVERED DESPITE PERSISTENT UNCERTAINTY

THE 2015 AUSTRALIAN VALUE Creators Report was titled *Creating Value through Growth in Uncertain Times*. Fast-forward one year and uncertainty remains a pervasive theme across the globe. The Brexit vote, the US election, and concerns over the strength of the Chinese economy have sent regular jitters through financial markets over the past 12 months.

Despite a recovery in commodity prices over the past year, Australia's GDP contracted by 0.5% in Q3 of 2016 – the first quarter of negative growth since March 2011 and only the fourth since July 1991. Inflation, at 1.3% year-on-year in September 2016, is at its lowest point in 17 years, and the cash rate is at an all-time low of 1.5%.

While GDP recovered in Q4 2016, the outlook for 2017 remains uncertain. Nonetheless, it appears likely that Australia will break the developed world record of 103 consecutive quarters without a technical recession (currently held by the Netherlands).

ASX 200 rebounded, while global markets were in two speeds

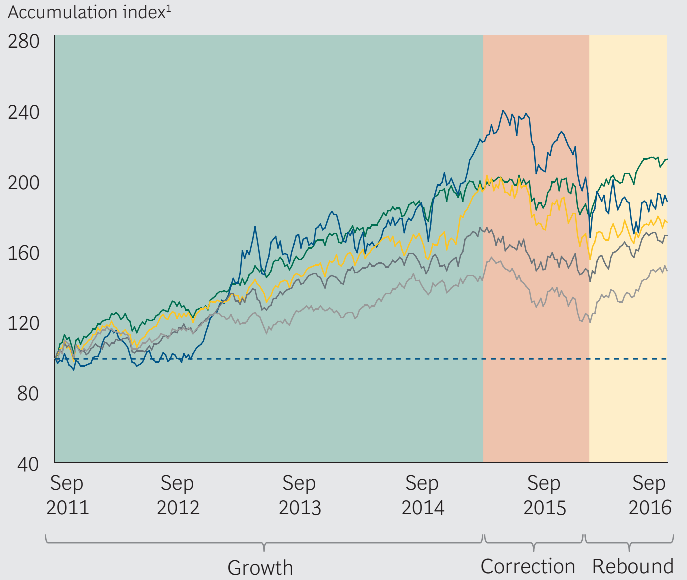
In 2016, Australia's ASX 200 delivered a robust one-year TSR of 13.2%,[3] a strong rebound from -0.7% in 2015. Similarly, the US bounced back with a 15.4% TSR in 2016 from -0.6% in 2015. Emerging Markets also recovered with a 15.5% one-year TSR in 2016, following a -7% return in 2015 (Exhibit 1).

Europe delivered an uninspiring one-year TSR of 2.5%, broadly in line with 2015. Japan contracted by -5.6% in 2016, reversing the 7.1% result in 2015.

Taking a longer-term view, Australia's five-year TSR was a solid 11.2% per year, but still trails the US at 16.4%, Japan at 13.7%, and Europe at 12.2%. Despite a strong year, Emerging Markets continue to lag the developed economies with a five-year TSR of 8.5% per year.

EXHIBIT 1 | S&P ASX 200's one-year return was similar to the S&P 500 and S&P Emerging LargeMidCap

TSR performance by major market



	One-year TSR[2] (September 2015–16)	Five-year TSR[3] (September 2011–16)
US (S&P 500)	15.4%	16.4%
Japan (S&P TOPIX)	–5.6%	13.7%
Europe (S&P EUR)	2.5%	12.2%
Australia (S&P ASX 200)	13.2%	11.2%
EM (S&P Emerging LargeMidCap)	15.5%	8.5%

1. Index = 100 at 30 September 2011
2. 30 September 2015 to 30 September 2016
3. 30 September 2011 to 30 September 2016
Source: S&P Capital IQ, BCG analysis

UNDERSTANDING THE DRIVERS OF TSR

Total Shareholder Return (TSR) measures the combination of share price gains and dividend yield for a company's stock over a given period of time. It is the most comprehensive metric for measuring a company's shareholder value creation performance.

Each year in the *Value Creators* series, we apply BCG's TSR disaggregation model to a sample of companies from five major indices: the US S&P 500, Japan's S&P TOPIX, Europe's S&P EUR, the ASX 200 and the S&P Emerging Markets LargeMidCap.

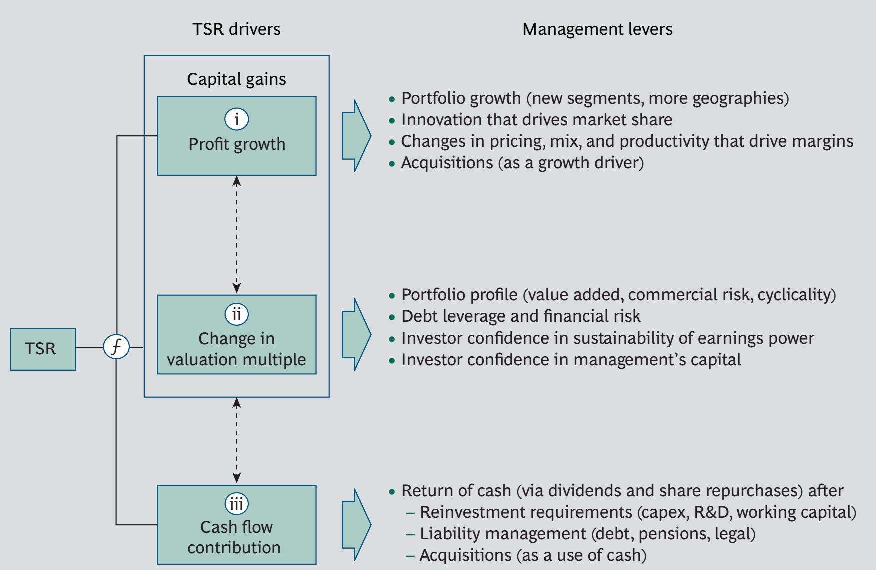
The model breaks down TSR into:

- **Profit growth** = growth in after-tax profit, measured as growth in revenue and change in net profit margin.
- **Multiple change** = change in historical price to earnings ratio.
- **Cash flow** = free cash flow to equity holders, measured as dividend yield and change in shares outstanding.

The model uses the combination of revenue (sales) growth and change in margins as an indicator of a company's improvement in fundamental value. It then uses the change in the company's valuation multiple to determine the impact of investor expectations on TSR. Together, these two factors determine the change in a company's market capitalisation and the capital gain or loss to investors. Finally, the model tracks the distribution of free cash flow to investors and debt holders in the form of dividends, share repurchases, and repayments of debt to determine the contribution of free cash flow payouts to a company's TSR. Management levers for each key element are summarised in the diagram below.

NOTES
We excluded companies with non-meaningful multiple changes, volatile results and less than five years of financials

TSR is the product of multiple factors



Source: BCG analysis.

Australia's 2016 TSR was underpinned by solid profit growth

We used BCG's TSR disaggregation model to understand the drivers of market performance. The model disaggregates TSR into:

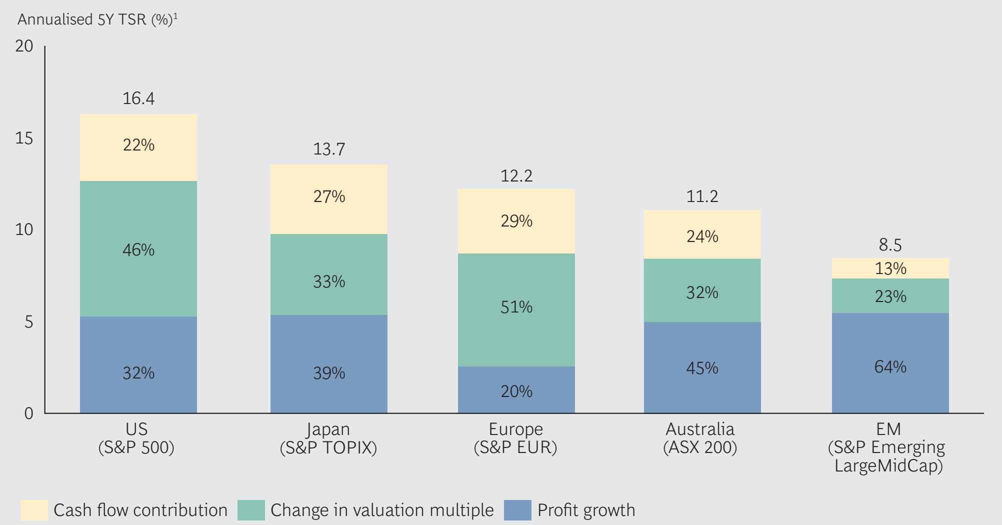
i. profit growth
ii. change in valuation multiple
iii. cash flow contribution

See *Understanding the drivers of TSR* on page 8.[4]

This analysis allows us to understand what drove Australia's TSR performance relative to other markets.

Australia's five-year TSR performance was underpinned by solid profit growth, with lower relative contributions from cash flow and change in valuation multiple (Exhibit 2). Cash flow was a noticeably small contributor in Australia, which may be contrary to expectation given Australia's favourable dividend imputation credit policy. However, further investigation into the drivers of cash flow revealed that although Australia did receive the strongest contribution from dividends of all the markets, this was offset by equity issuance.

EXHIBIT 2 | ASX 200 TSR performance underpinned by solid profit growth
TSR disaggregation by market



1. 30 September 2011 to 30 September 2016
Notes: TSR is disaggregated using Price to Earnings multiple for banks and diversified financials, Price to Book multiple for insurance, and Enterprise Value to EBITDA multiple for all other industries. TSR calculated in AUD
Source: S&P Capital IQ, BCG analysis

While the TSR disaggregation of Japan's market is similar to Australia's, Japan has experienced stronger TSR over the five-year period.

In the US and Europe, however, the strongest driver of TSR was change in valuation multiple, reflecting improving growth expectations. Cash flow made a similar contribution in both markets. Weak profit growth in Europe suggests that companies are struggling to identify and capitalise on the next wave of growth opportunities.

The recovery in TSR in Emerging Markets was driven by profit growth. Of all the markets, this index experienced the smallest contributions from change in valuation multiple at 23% and cash flow at 13%.

NOTES

3. September 2015 to September 2016

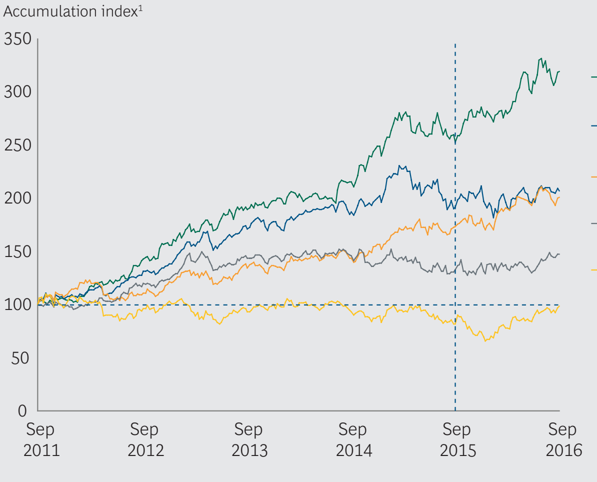
4. TSR is disaggregated using Price to Earnings multiple for banks and diversified financials, Price to Book multiple for insurance, and Enterprise Value to EBITDA multiple for all other industries

WHICH AUSTRALIAN SECTORS DROVE THE REBOUND IN 2016?

To understand Australia's performance, we analysed the performance of the ASX 200 at a sector level. The ASX 200 is comprised of 11 major sectors, and in this section we discuss the five largest: Healthcare, Financials, Industrials, Consumer Staples and Mining/Materials.[5] Detail on the performance of the remaining sectors (Energy, Telecommunication Services, Consumer Discretionary, Utilities, Real Estate, and IT) and three subsectors of the Financials sector (Banks, Insurance, and Diversified Financials) is presented in Appendix 2.

In 2016, Healthcare, Industrials and Mining/Materials all delivered one-year TSRs above the ASX 200, while Financials and Consumer Staples TSR performed below the index. Healthcare, Industrials and Financials outperformed the ASX 200 on a five-year TSR horizon, while Consumer Staples and Mining/Materials underperformed the index. Notably, Mining/Materials was the only one of these five sectors to deliver a negative five-year TSR.

EXHIBIT 3 | Four of the top five sectors delivered a strong TSR in 2016
TSR of the ASX 200's five largest sectors



	One-year TSR[2] (September 2015–16)	Five-year TSR[3] (September 2011–16)
Healthcare	25.5%	26.1%
Financials	8.2%	15.7%
Industrials	17.5%	15.0%
Consumer staples	12.7%	8.1%
Mining/materials	22.6%	–0.3%
ASX 200	13.2%	11.2%

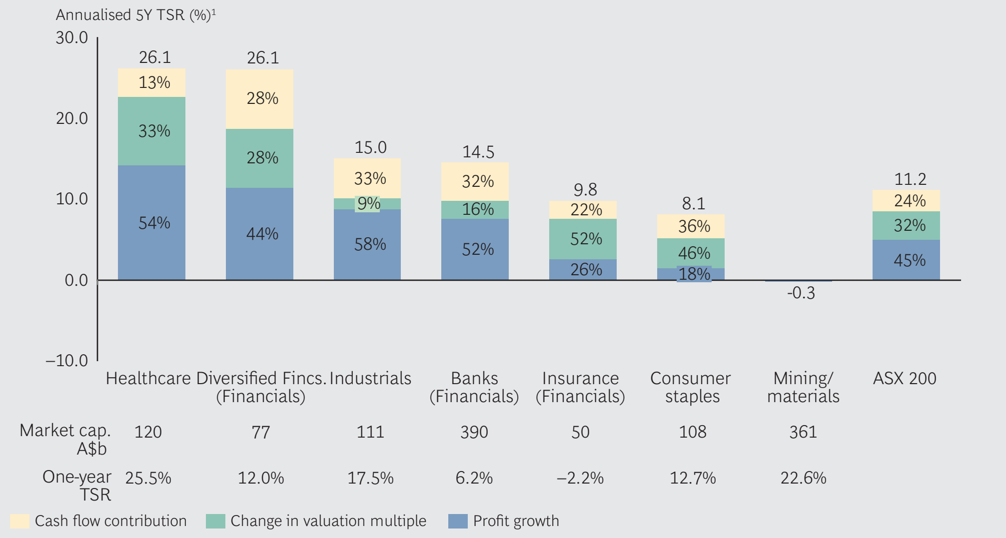
1. Index = 100 at 30 September 2011
2. 30 September 2015 to 30 September 2016
3. 30 September 2011 to 30 September 2016
Source: S&P Capital IQ, BCG analysis

What drove TSR in each of these sectors?

We applied our TSR disaggregation tool to each of these five sectors. We separated the Financials sector into Banks, Insurers, and Diversified Financials, due to their different drivers.[6] Our analysis showed that the main driver of five-year TSR for most sectors analysed was profit growth (Exhibit 5). The only industries in which change in multiple was the major driver were Insurance and Consumer Staples.

EXHIBIT 4 | The drivers of TSR vary by sector

TSR disaggregation of ASX 200 sectors



1. 30 September 2011 to 30 September 2016

Notes: TSR is disaggregated using Price to Earnings multiple for banks and diversified financials, Price to Book multiple for insurance, and Enterprise Value to EBITDA multiple for all other industries. TSR calculated in AUD

Source: S&P Capital IQ, BCG analysis

Healthcare

In 2016, Healthcare again led the largest industry sectors with a one-year TSR of 25.5%, significantly outperforming the ASX 200 index one-year return of 13.2%.

Healthcare's five-year TSR delivered similar outperformance at 26.1% per year, which is comfortably above the AXS 200 five-year return of 11.2%. The primary contributor to this outperformance was strong profit growth, with change in valuation multiple largely responsible for the remainder.

Mining/Materials

The Mining/Materials sector rebounded in 2016 with a one-year TSR of 22.6%, as commodity prices (particularly iron ore and coal) recovered significantly. However, the sector's five-year TSR is -0.3% per year.

Industrials

Industrials delivered a one-year TSR of 17.5% and a five-year return of 15.0% per year, both outperforming the ASX 200 benchmark. Consistent with many of the sectors, the majority of the five-year TSR performance was delivered from profit growth.

Consumer Staples

Consumer Staples bounced back from a negative result in 2015, with a one-year TSR of 12.7% in 2016. This was delivered by expanding valuation multiples and the continuation of high dividend payout policies. However, the sector's five-year TSR of 8.1% per year was below the benchmark.

Financials

Financials, the largest sector by market capitalisation in the ASX 200, underperformed the benchmark in 2016 with a TSR 8.2%.However, its five-year return remains well in excess of the ASX 200 at 15.7% per year.

Of the three Financials sub-sectors (Banks, Insurers, and Diversified Financials), Diversified Financials is the stand-out performer with a five-year TSR of 26.1% per year. It is interesting to note that this has been achieved through a balanced contribution from all three drivers of TSR.

The five-year TSR for Banks, at 14.5% per year, was driven by both profit growth and cash flow contribution. However, headwinds within the sector suppressed change in valuation multiple.

Insurance is notable for relying largely on change in price-to-book multiple for its TSR result. The continuation of high dividend policies was mostly offset by new equity issuance.

NOTES

5. Measured by market capitalisation at 30 September 2016

6. TSR is disaggregated using Price to Earnings multiple for Banks and Diversified Financials, Price to Book multiple for Insurance, and Enterprise Value to EBITDA multiple for all other industries

WHO WERE THE TOP PERFORMERS, AND HOW DID THEY CREATE VALUE?

To understand how Australia's leading companies have created shareholder value over time, we analysed companies that were listed on the ASX 200 for at least five years in 2016.[7]

Exhibit 5 | Top quartile ASX 200 companies delivered a TSR of at least 26% per year over the last five years

ASX 200 top quartile performers in 2016

Rank	Company name	Industry	Market Cap (A$m)	5 year TSR (2011–2016)[1]
1	Altium Limited	Information Technology	1,199	149.2
2	Magellan Financial Group	Financials	3,506	85.0
3	Corporate Travel Management Limited	Consumer Discretionary	1,757	66.8
4	Domino's Pizza Enterprises Limited	Consumer Discretionary	6,247	65.6
5	Australian Pharmaceutical Industries Limited	Healthcare	944	62.4
6	Northern Star Resources Limited	Materials	2,799	60.4
7	Aristocrat Leisure Ltd.	Consumer Discretionary	10,073	53.5
8	G8 Education Limited	Consumer Discretionary	1,154	52.2
9	Sirtex Medical Limited	Healthcare	1,820	50.2
10	Mayne Pharma Group Limited	Healthcare	2,984	49.8
11	Webjet Ltd.	Consumer Discretionary	1,167	48.9
12	TPG Telecom Limited	Telecommunication Services	7,314	46.2
13	TechnologyOne Limited	Information Technology	1,861	45.5
14	Fisher & Paykel Healthcare Corp. Limited	Healthcare	5,667	43.2
15	BT Investment Management Limited	Financials	2,334	42.0
16	Credit Corp. Group Ltd.	Financials	875	41.7
17	REA Group Limited	Consumer Discretionary	7,435	39.3
18	Macquarie Group Limited	Financials	26,255	36.2
19	Blackmores Limited	Consumer Staples	2,008	35.9
20	Retail Food Group Limited	Consumer Discretionary	1,224	35.6
21	Ramsay Health Care Limited	Healthcare	15,799	35.6
22	Vocus Communications Limited	Telecommunication Services	3,815	35.3
23	James Hardie Industries plc	Materials	8,953	35.2
24	Macquarie Atlas Roads Group	Industrials	2,645	34.7
25	Bega Cheese Limited	Consumer Staples	1,013	33.3
26	Charter Hall Group	Real Estate	2,109	32.8
27	CSL Ltd.	Healthcare	48,782	31.7
28	Breville Group Limited	Consumer Discretionary	1,138	30.9
29	Premier Investments Limited	Consumer Discretionary	2,438	30.3
30	Sydney Airport Limited	Industrials	15,681	29.9
31	Ardent Leisure Group	Consumer Discretionary	1,299	29.7
32	Caltex Australia Ltd.	Energy	8,933	29.2
33	Cochlear Ltd.	Healthcare	8,092	28.9
34	Infigen Energy	Utilities	628	28.5
35	Tassal Group Limited	Consumer Staples	602	27.9
36	Orocobre Limited	Materials	781	27.4
37	Treasury Wine Estates Limited	Consumer Staples	8,135	27.4
38	Spark New Zealand Limited	Telecommunication Services	6,609	27.2
39	SEEK Limited	Industrials	5,391	26.8
40	DuluxGroup Limited	Materials	2,525	26.2

1. 30 September 2011 to 30 September 2016
Notes: TSR calculated in AUD
Source: S&P Capital IQ, BCG analysis

Top-quartile threshold returned to 2009 levels

The threshold for top quartile five-year TSR is volatile. In 2016, it reached 26.2% per year – the highest level since 2009 (Exhibit 7). However, it is interesting to note that it remains well below the peak of 42.2% per year in 2007.

Relative to the market median, the level of outperformance required to achieve top quartile has been reasonably constant since 2011, at between 8% and 11% per year above median TSR. In 2016, the ASX 200 median TSR was 16.8% per year, implying that top quartile firms outperformed by at least 9% per year. By contrast, from 2007–10, top quartile firms outperformed by around 16% per year. This observation underlines the growing challenge that companies face to consistently separate themselves from the pack.

A diversified set of companies returned to the ASX 200 top quartile in recent years

All sectors had at least one top quartile ASX 200 performer in 2016. While this happened each year from 2014 to 2016, it did not happen once from 2004 to 2013.

The sector composition of the top quartile has changed considerably over the past decade (Exhibit 7). In 2009, Mining/Materials and Energy companies represented more than 75% of top quartile firms. Their dominance has declined over time and today no one sector represents more than 25%.

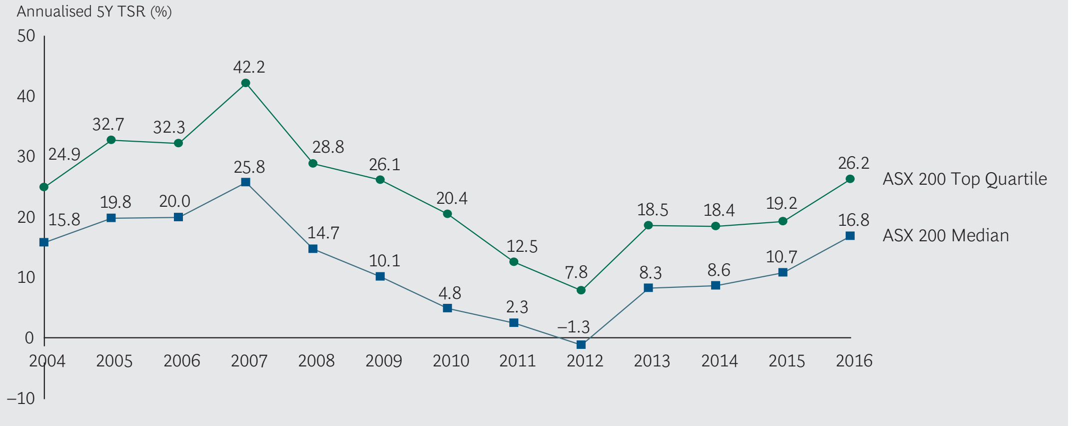
All sectors and sizes deliver top-quartile performers

The distribution of top-quartile companies by market capitalisation broadly mirrors that of the broader ASX 200.

In 2016, the Consumer Discretionary sector had the most companies in the top quartile with 10, although it also had the highest number of eligible companies with 30 of the 160 (Exhibit 8).

Telecommunication Services was the most over-represented, with 75% of ASX 200 companies in the sector in the top quartile. Recent consolidation in the industry and high dividend yields are likely to have influenced this. Healthcare is also strongly over-represented – 58% of ASX 200 Healthcare companies achieved top quartile TSR, reflecting very strong profit growth over the past five years.

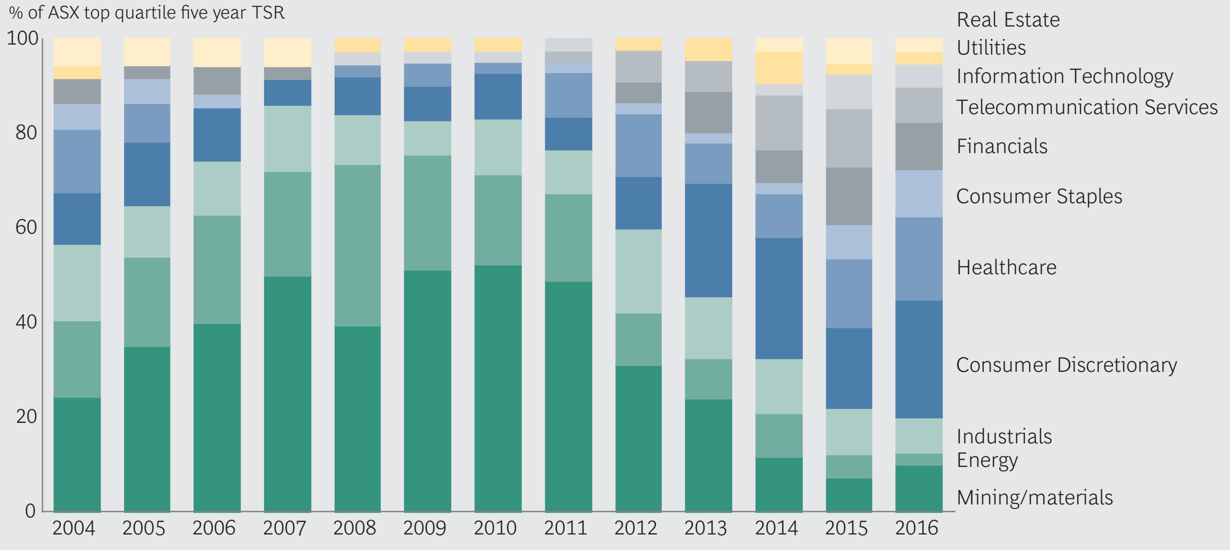
Exhibit 6 | Top quartile TSR threshold for ASX 200 reached 26%
Threshold for achieving top quartile and median TSR of ASX 200 over time



Notes: Five-year TSRs run from 30 September to 30 September for ASX 200 constituents at that time. Calculated in AUD
Source: S&P Capital IQ, BCG analysis

Exhibit 7 | ASX 200 top quartile has diversified in recent years

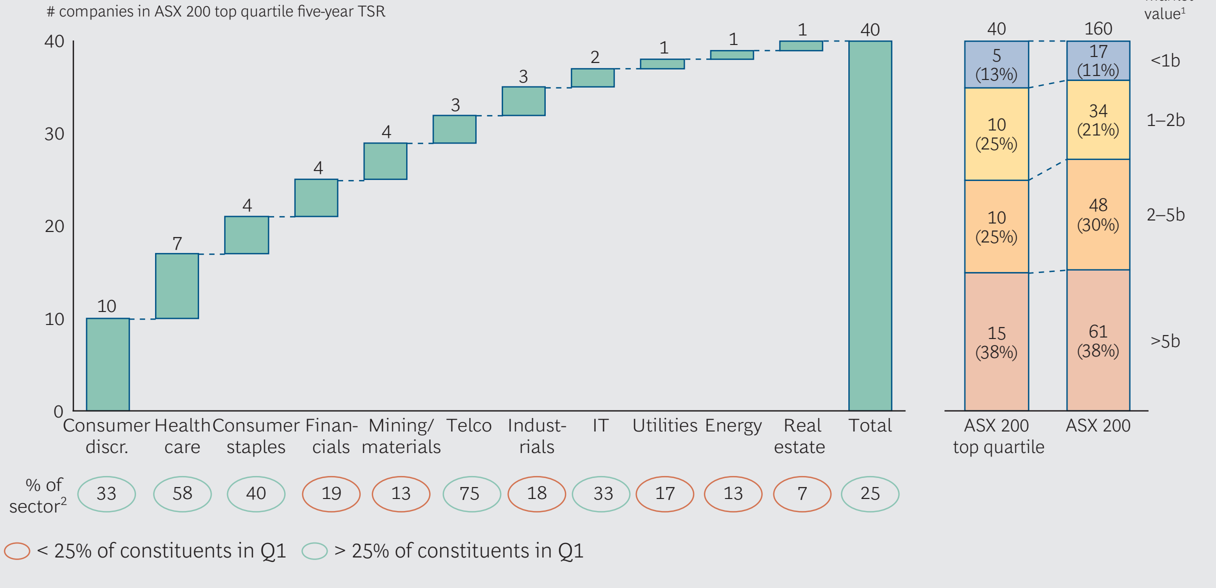
Percentage of ASX 200 top quartile constituents by sector



Note: Five-year TSRs are from 30 September to 30 September for ASX 200 constituents at that time. Calculated in AUD
Source: S&P Capital IQ, BCG analysis

Exhibit 8 | All sectors and sizes delivered top quartile performers

Top quartile performers by sector and size



1. As at 30 September 2016
2. As % of the total companies included in the five-year TSR analysis
Notes: Market capitalisation calculated in AUD
Source: S&P Capital IQ, BCG analysis

At the opposite end of the spectrum, the Energy, Utilities, and Real Estate sectors each had one representative in the top quartile. Energy's poor result reflects a broader weakness in the sector, which is a symptom of soft oil and coal prices over the past five years.

Only 13% of Mining/Materials companies reached the top quartile, despite recent recoveries in commodity prices.

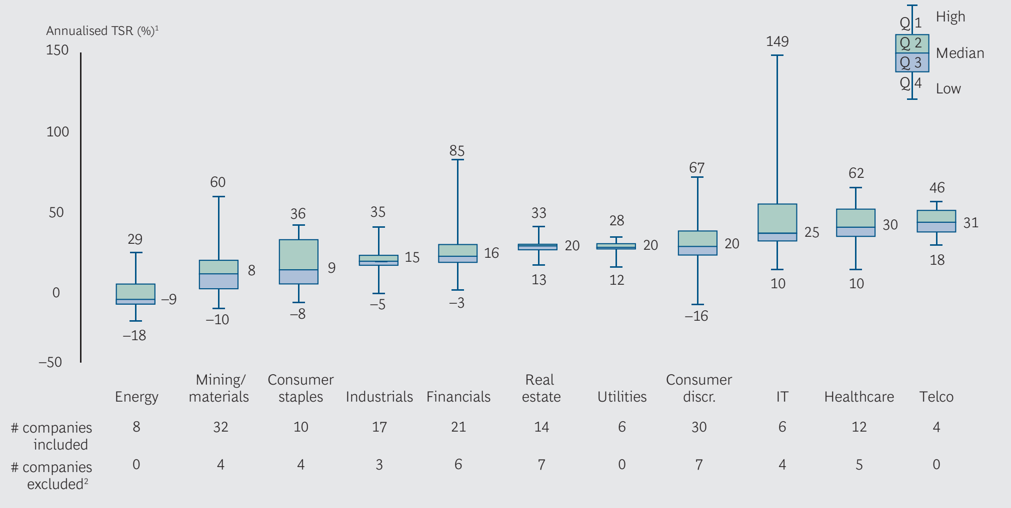
Volatility of returns varies across sectors

While all sectors had standout performers, the volatility of returns within sectors is variable.

The Utilities and Real Estate sectors both had relatively tight TSR ranges around medians of approximately 20% per year. The top and bottom performers in Utilities were separated by 16 percentage points and in Real Estate by

EXHIBIT 9 | Strong value creators were found in all sectors

TSR performance by sector and quartile



1. From 30 September 2011 to 30 September 2016
2. Companies without five years of trading have been excluded from analysis
Source: S&P Capital IQ, BCG analysis

20 percentage points. Conversely, the IT sector was more volatile it had almost 140 percentage points between the top and bottom performers and still delivered a 24.5% per year median TSR.Most top quartile performers delivered revenue growth and margin expansion

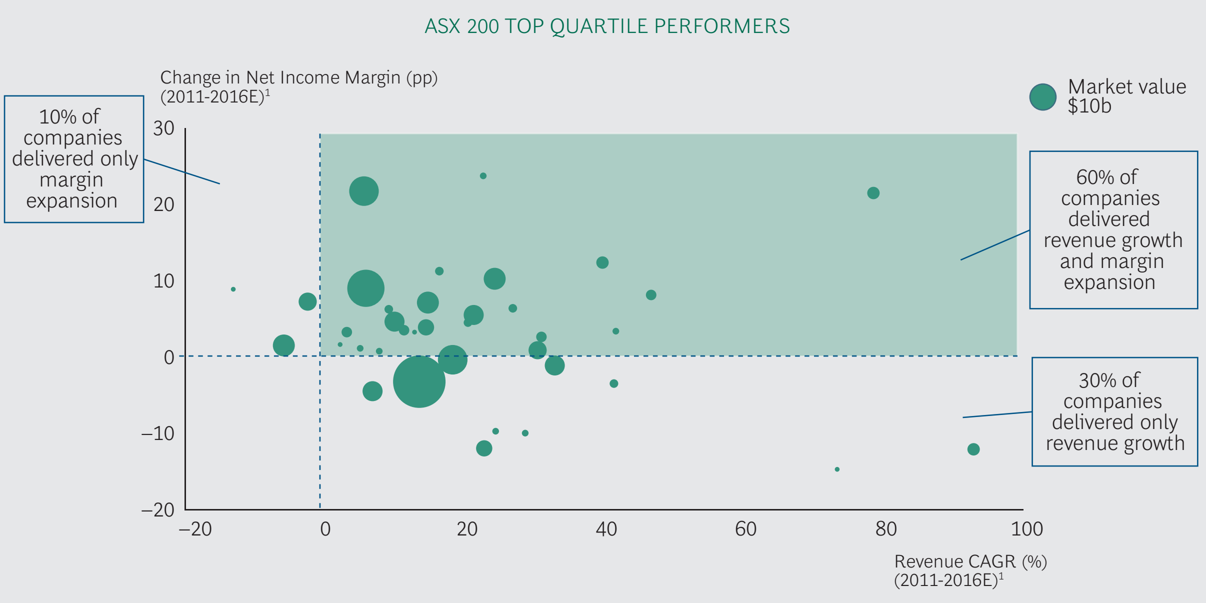
Profit growth, and in particular revenue growth, continued to be the primary driver of sustainable TSR. Similar to 2015, 90% of top quartile companies were able to grow revenue from 2011 to 2016 (Exhibit 10).[8] Just 10% of companies delivered top quartile performance based on margin improvement alone.

While it seems impressive that 90% of top quartile companies grew revenue, 80% of companies outside the ASX 200 top quartile also did so. However, while 60% of top quartile companies expanded both revenue and margin, only 40% of non-top quartile companies achieved this feat. Clearly, there is more to delivering shareholder value than revenue growth. Management teams need to deliver sustained profitable growth to drive value creation.

NOTES
8. This figure drops to 70% when adjusted for inflation

EXHIBIT 10 | Most top quartile companies delivered both revenue growth and margin expansion

Change in net profit margin and revenue growth for top quartile performers



1. When companies had not reported FY16 actual financials by 30 September 2016, we used consensus estimates from Capital IQ
Notes: One outlier with excessively large ratios has been excluded from the exhibit. Change in net income margin is based on normalised net income. All calculations are in AUD
Source: S&P Capital IQ, BCG analysis

UNLEASHING YOUR INNER ACTIVIST

CREATING VALUE AS A MANAGEMENT TEAM IS ALWAYS A CHALLENGE, especially through persistent uncertainty. We are seeing a growing number of shareholder activists using different levers to unlock value. By taking an outsider's perspective, management can replicate these value creation strategies.

Activism is maturing in the US and rising in Australia

Activism is growing in earnest in Australia. In coming years, our corporate leaders may find themselves in a paradigm similar to their counterparts in the US, where approximately 21% of the S&P 1500 has been targeted by activist campaigns over the past 10 years. Even companies that have not faced a campaign themselves may see their peers being targeted.

Activists are well established in the US and often target companies of more than $1b in market cap (and more than $100b in extreme cases like Qualcomm and P&G). Historically in Australia, activist activity has largely been targeted at smaller companies (often less than $500m in market cap). We, along with most observers and market participants, expect this to change as local activism grows and becomes more entrenched.

Activist Insight, along with Australian law firm Arnold Bloch Leibler, lists several foreign activists that visited Australia recently to launch public campaigns, including Coliseum Capital, The Children's Investment Fund Management, and Lone Star Value Management. While 85% of companies targeted since 2013 have had a market capitalisation of less than ~$330m, Arnold Bloch Leibler notes that, "for larger Australian companies, the question is likely to be 'when', not 'if'".[9]

Not only has the number of campaigns in Australia been growing, but the focus of these campaigns has been shifting. Since 2011, most activist campaigns have been targeted at changes to boards. However, J.P.Morgan estimates that the number of campaigns grounded on value maximisation themes, which propose specific value creation theses rather than merely board spills, has grown at 40% per year from 2011–15, higher than the 30% for overall campaigns. This is particularly so for companies with a market capitalisation of over $1bn; J.P.Morgan suggests over 50% of campaigns directed at this group between 2011–16 have had at least one specific value proposition.[10] For companies under $1bn market capitalisation, this was the case only 15% of the time.[11]

Active shareholder styles cover a spectrum

Activism is not limited to agitators with a short time horizon and a preference for value creation levers (such as balance sheet engineering or breaking up the company) that have little to do with business fundamentals or strategy. Many activists have more constructive approaches, based on private dialogue with management and an effort to convince management to change business strategy or operating principles. Just as returns in private equity have required investors to become more operational in their approach and deeply understand the businesses they invest in, the competition in shareholder activism has also shifted toward operations. This shift is well established in the US, and we expect it to follow in Australia as the activism landscape matures.

Our experience suggests that activist shareholders exist across a wide spectrum, ranging from pure agitators to pure collaborators.

Pure agitators hold activism as a central theme in their investment thesis. They're not afraid to engage publicly, and their time horizons can be quite short – often as brief as six months.

Reluctant agitators sit somewhere in between. While reluctant agitators prefer to engage management privately, management teams know that ultimately they are willing to agitate publicly if necessary.

Pure collaborators typically engage receptive management privately to avoid public confrontation. They will approach management with a value-creation agenda, the result of months or years of diligent research, with the goal of initiating fundamental change that creates long-term shareholder value.

To some extent, the positioning of activist investment funds across this spectrum is agnostic of their preferred time horizon. Pure agitators have been known to sit on positions for three-to-five years or more, while pure collaborators may sell out within two-to-three years if their price target is reached.

BLUESCOPE STEEL
The Cheapest Steel Company in the World

One example in Australia is Sandon Capital's approach to BlueScope Steel. In June 2015, Sandon laid out a long-term strategy with BlueScope's management shortly after investing, describing BlueScope as the "Cheapest Steel Company in the World".

Sandon's investment thesis included several portfolio restructuring plays, including mothballing the Port Kembla steel mill, and improving capital management and cutting operational costs.

Management adopted many of these strategies with great success. They cut operational costs significantly, although the Port Kembla steel mill is still operating. BlueScope's share price has increased by over 130% (as of 30 September 2016), since the announcement of this strategy in June 2015.

Outside-in perspective of activists can help management identify and unlock value opportunities

What does all this mean? Activists' value theses are often consistent with moves that management may have been contemplating, and which a broader set of shareholders might support. By proactively assessing the activist thesis, management can determine which moves it might support (and pre-emptively execute), and which might appeal to investors, but could be refuted through more rigorous and articulate investor communications. We call this approach "do-it-yourself" activism.[12] Many of our clients have used it to strengthen the logic for hard strategic changes (such as cost cuts or forcing a business unit to shift its focus from growth to returns). Some clients have even used it to initiate large-scale transformations that include radical changes to the corporate portfolio and cost structure.

In our experience from working with large global corporations, we have observed six levers that highlight opportunities for value creation. By thinking like an activist, management can take actions to unlock shareholder value (Exhibit 11).

WHAT CAN CORPORATE AUSTRALIA LEARN FROM ACTIVIST INVESTORS?

John Ho, Founder and Chief Investment Officer of Janchor Partners shares his perspective

Over the past decade, Hong Kong-based Janchor Partners has made a number of investments in ASX-listed public companies – including rail freight operator Aurizon, information and governance management provider Recall, credit reporting and analytics company Veda, and former government-owned private health insurer, Medibank Private.

John Ho is convinced that activist investors are increasingly seeking opportunities in the Australian market. Furthermore, he believes that the well-publicised and notable examples of activism in the public domain represent only a small portion of the action. "The outlook for a more engaged style of investing will continue to improve. It is only going to become more significant... this is the tip of the iceberg" he says.

In addition, Mr. Ho believes that a collaborative mindset characterises many investors in the Australian market, and their preference is to engage and partner with corporates in driving value creation. "Engagement is, by definition, a two way dialogue… We want the company to take something away from the meeting as much as we do." He explained the Janchor approach of engaging early with management, and their subsequent adoption of an iterative and sequential approach. "After a while we get sharper and sharper, we should gain more and more respect, and we will ask more nuanced questions. It is a process of mutual trust building."

Mr. Ho believes that Australian firms should see the growth of activism as an opportunity to both learn and potentially, a license to be bolder in their approach to strategy. More engaged shareholders bring an objective, strategic perspective on the business – and can prompt a healthy dialogue, the pressure-testing of strategy, and offer management a perspective on opportunities that can be difficult to identify when focused on day-to-day operations.

Finally, in a direct challenge to the criticism often levied at activist investors, Mr. Ho underlines his focus on long-term value creation. Mr. Ho says that despite the clear need for longer-term lens, many corporates retain a focus on an agenda and planning cycle built around quarterly or semi-annual result reporting. Ultimately, he sees potential for companies to adopt a longer-term focus with the support and encouragement of company Boards. "For the companies that I am exposed to, I want to challenge them to become more like that, more longer-term focused. It is all about making incremental mindset shifts. If we focus on doing that, we are going to make a difference, and we will have created value for the company." Mr. Ho describes this as "industrialist investing", which he considers to be Janchor's brand of activism.

Portfolio strategy is a common lever that activists use to identify value creation opportunities. While management will often focus on measures such as revenue growth, earnings per share and profitability, activists will break a company into the sum of its parts for their valuation. If this is greater than the market value of the company, value may be unlocked by divesting parts of the group, reconsidering portfolio roles for each business unit, or reallocating capital according to TSR potential.

A company's **financial policies** are another lever to identify opportunities for value creation. A review of dividend payout policies and share repurchase plans can reveal unlocked value within the organisa-

Exhibit 11 | Six levers to identify and unlock shareholder value through an activist's lens

Activist time horizon

Levers	Identifiers	Value levers
1 Portfolio strategy	• Sum of the Parts > trading price • Consensus value > trading price • Low P/E or EV/EBITDA vs. peers	Sell the company or part of the company, reassess portfolio roles, or reallocate capital according to TSR potential
2 Financial policies	• Excessively high cash balance	Return more cash to shareholders
3 Capital structure	• Low leverage ratio low vs. peers	Increase leverage ratio
4 Capital allocation	• Low ROGI vs. peers • High capex % of sales vs. peers	Shift investments among business segments
5 Governance	• Compensation not tied to TSR • Board very long standing and / or inexperienced in industry	Changes in Board composition or executive policies
6 Business performance	• SG&A high % of revenue • Low TSR relative to peers	Improve business strategy, execution capabilities or cost structure

Source: BCG experience

tion. For example, given that cash on a balance sheet is often valued at less than face value, using it to fund a share buyback can be a quick way to release value to shareholders. However, this must be tempered by an understanding of the holding value of cash within the relevant industry. For example, in an industry with high volatility and requirements for large capital deployments, preserving cash buffers can be of greater strategic importance.

Another identifier on the balance sheet is the **capital structure** of a company, particularly a lower leverage ratio than industry peers. Higher levels of debt financing lower the overall cost of capital of the company, and provide more funds to invest in the company or return to shareholders.

If a company or business unit return on gross investment (ROGI) is lower than its peers, an activist may perceive management's **capital allocation** – another lever – as suboptimal. By cutting growth funding to low-return businesses, management could free up excess cash to invest in more attractive business segments.

A long standing or entrenched board with close ties to management, or one that lacks experience in an industry, can indicate opportunities to improve **governance**. Similar opportunities may exist in a company where executive compensation is not tied to TSR or its key drivers. Improving relevant experience on a board can help improve the strategic direction of a company. Aligning executive pay with shareholder interests can also improve investor perceptions.

The final lever is business performance. Poor **business performance** is a common indicator of suboptimal business strategy and/or execution, which can be identified through poor relative TSR performance versus the market and peers. Improving strategy, execution capabilities, or cost structure is a sure-fire way of unlocking shareholder value, although this can take years of dedicated effort.

These six levers can be used to identify areas of opportunity, and to unlock much of the value that an active shareholder will look to add. Management has an opportunity to take on an activist mindset by identifying these levers, and pre-emptively using them to drive long-term value for shareholders.

QANTAS
Unlocking the value of Qantas Frequent Flyer

Another example involves a consortium of Australian investors, including former Qantas executives, who saw an opportunity for Qantas to change strategy. The consortium purchased a stake of less than 2% of Qantas in mid-2012. They believed the stock was undervalued, and encouraged management to pursue a float or sale of the Frequent Flyer business unit – a valuable piece of the company's portfolio.

The consortium was unable to convince management or rally enough support from institutional investors. When the Australian Competition and Consumer Commission approved a tie-up with Emirates in January 2013, the consortium sold its stake. Its exit price was reportedly over $1.50 per share, a more than 30% increase on the estimated entry price eight months earlier.

Qantas has resisted floating or selling its Frequent Flyer business and it remains a critical part of its portfolio. Since this experience, Qantas has invested significantly in this part of the business with ventures such as Qantas Assure.

First steps to employ a "do-it-yourself" mindset to activism

So, where to next? One approach management can take to identify and address these six levers holistically is by creating and deploying an integrated TSR strategy.

A comprehensive and robust strategy will focus on three areas: business strategy, financial strategy, and investor strategy.

Managers can start their **business strategy** with a holistic, evidence-based view of the company's TSR, based on existing plans. They can then look across the portfolio to understand and refine the contribution of individual business units to the corporate TSR target. This will enable the company to get the most out of each business unit, and pull the right levers to unlock value.

Successful leaders will also develop a **financial strategy** which aligns with the company's long-term objectives, and includes a clear plan for use of free cash flow. This involves striking the right balance between cash retained on the balance sheet, share buy backs, and dividend payments, while also considering the optimal capital structure and credit rating. Decisions should be made with a holistic view of their impacts, and be linked to the overall value creation strategy.

Concurrently, management can devise an **investor strategy** which segments the company's investors into categories, defines the right investor type for the company, and makes sure the company's value creation strategy reflects the priorities and expectations of each investor group. This will help to build investor support for the value creation opportunity.

Taking these steps will provide an outside-in perspective on company performance, and provide a platform for management to adopt an activist mindset and approach. Management can then take an integrated approach to identifying and deploying the six levers of activist investing to support long-term value creation.

NOTES

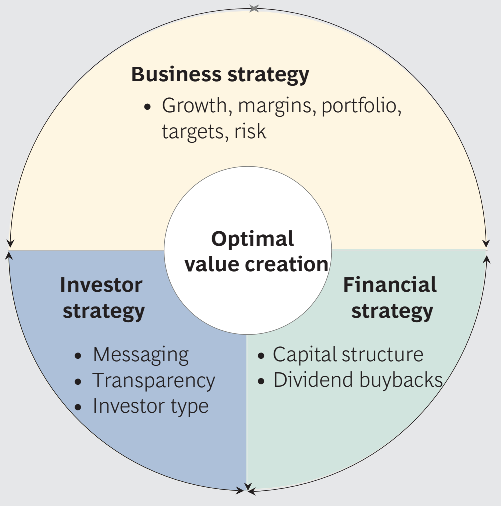
9. Shareholder activism in Australia: A review of trends in activist investing, Activist Insight, in association with Arnold Bloch Leibler (2016)

10. Includes the following campaign types: board control and representation, enhance corporate governance, remove director(s), remove officer(s), and vote/activism against a merger

11. Shareholder activism in Australia: Navigating the evolving landscape, J.P.Morgan (2016)

12. For further reading, see "Do-It-Yourself Activism", a February 2014 article by the Boston Consulting Group

Exhibit 12 | Integrated approach to value creation



- Build a shared fact base
- Develop and debate alternative scenarios
- Align around preferred goal, strategy and implementation sequence

APPENDIX 1: TSR PERFORMANCE BY INDUSTRY SECTOR

Exhibit 13 shows the market capitalisation, five-year and three-year TSR performance, current and historical forward PE ratios and market value to book ratios for sectors across the ASX 200.

Exhibit 13 | TSR Performance for Australian Industry Sectors

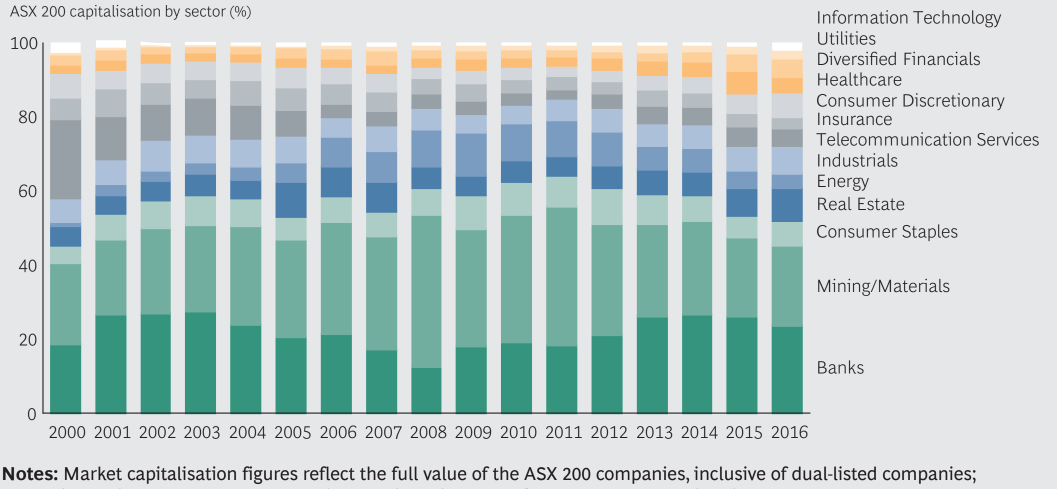
	Market capitalisation September 2016	One-year[1] TSR September 2015-16 (%)	Five-year[2] TSR September 2011-16 (%)	PE Ratio September 2011	PE Ratio September 2016
Banks	390	6.2	14.5	9.3x	12.4x
Mining/Materials	361	22.6	-0.3	8.4x	19.2x
Consumer staples	108	12.7	8.1	14.4x	19.2x
Industrials	111	17.5	15.0	14.4x	21.5x
Real estate	148	20.4	19.5	13.6x	17.4x
Energy	65	6.5	-4.5	18.1x	19.8x
Telecommunication services	81	-2.3	18.5	10.8x	15.3x
Consumer discretionary	108	29.5	17.6	10.4x	19.6x
Healthcare	120	25.5	26.1	16.6x	26.2x
Insurance	50	-2.2	9.8	9.9x	13.9x
Diversified financials	77	12.0	26.1	9.7x	15.1x
Utilities	39	18.8	17.5	14.2x	23.2x
IT	22	16.8	14.9	14.2x	22.4x
ASX200 total	**1,680**	**13.2**	**11.2**	**14.9x**	**16.5x**

1. 30 September 2015 to 30 September 2016
2. 20 September 2011 to 30 September 2016
Notes: Industries classified by GICS Sector groups, where the Financials Sector has been further broken into its Industry Group components
Source: S&P Capital IQ, BCG analysis

APPENDIX 2: ASX 200 MARKET CAPITALISATION BY INDUSTRY SECTOR

Exhibit 14 shows the distribution of ASX 200 market capitalisation by industry over time. In 2016, the distribution remained relatively similar to 2015. Since 2015, the shares of market capitalisation for the Banks and Healthcare sectors have decreased significantly, while the Consumer Discretionary and Real Estate have increased.

Exhibit 14 | ASX 200 market capitalisation by industry

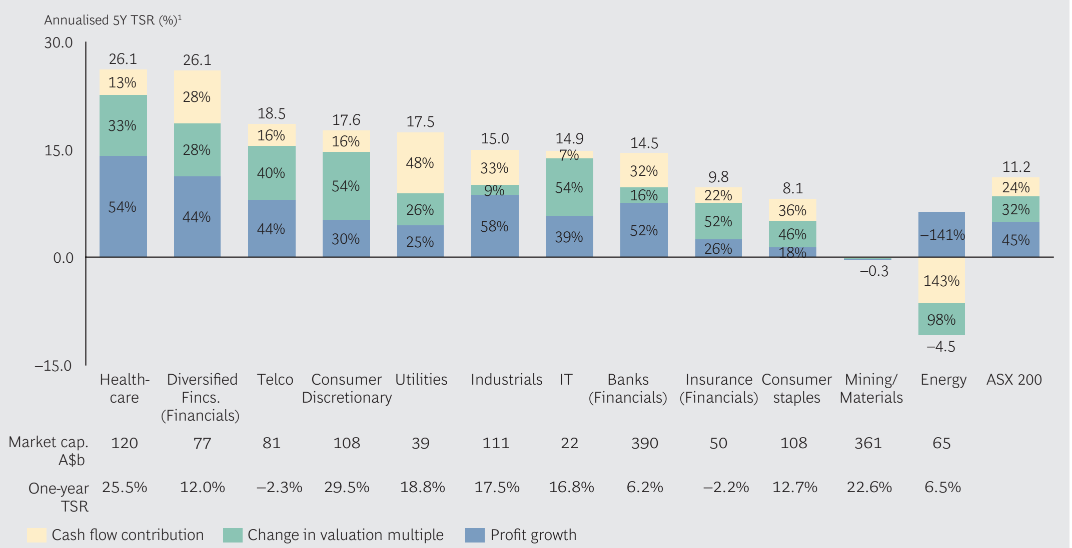


Notes: Market capitalisation figures reflect the full value of the ASX 200 companies, inclusive of dual-listed companies; Industries designated by GICS Sector, with the Financial Sector further broken down into its component Industry Groups; Market capitalisation shown as of 30th June from 2000 to 2015, and 30th September for 2016
Source: S&P Capital IQ, BCG analysis

APPENDIX 3: TSR DISAGGREGATION OF ASX 200 SECTORS

Exhibit 15 provides a TSR disaggregation across all eleven ASX 200 sectors, with Financials separated into Banks, Diversified Financials and Insurance.

Exhibit 15 | TSR disaggregation of ASX 200 sectors



1. 30 September 2011 to 30 September 2016
Notes: TSR is disaggregated using Price to Earnings multiple for banks and diversified financials, Price to Book multiple for insurance, and Enterprise Value to EBITDA multiple for all other industries. Real estate has been excluded from this analysis. TSR calculated in AUD
Source: S&P Capital IQ, BCG analysis

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NOTE TO THE READER

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