

Marks & Spencer: A challenge to management and an invitation to the public to contribute to the debate

A Message from David Blundell, Chairman of UKSA

18 June 2004

“The focus of the UK Shareholders Association is our role as investors, but these issues affect everybody. Whether or not you own shares in M&S, you may have a contribution to make to the discussion, and we welcome any contributions on the issues raised in this paper to debate@uksa.org.uk.

We undertake not to pass on e-mail addresses or any other personal information to anyone outside the executive of UKSA, unless people specifically request otherwise. If you would like a reply, please let us know and we will try, but we do undertake to publish in due course a summary of the contributions we receive, with possibly an interim summary before the M&S AGM. Not many people do contribute to this sort of thing; so if you do you will make a difference!

We don't know what will hit the headlines from this exercise. It could be our views about a long term versus a short-term investment horizon (doubtful, perhaps?). It may well be our hard-hitting suggestions about remuneration, particularly of executives. Finally, it could be the opportunity we present for anyone to contribute ideas not only on these high-profile issues – but also on the strategic questions, the opportunities and threats facing the business of M&S.

Whilst 20% of M&S is owned directly by individuals, a large proportion of the population will have an indirect interest in the company through a number of arrangements such as pension funds, PEPs, ISAs, unit trusts, life insurance, and investment trusts. We particularly welcome contributions from employees and customers of M&S. What should the business do / not do?

Why are we doing this? Frankly, it's too good an opportunity to miss. The fact that the Company has promised to set out a strategy in July has nothing to do with it. The Company would look pretty silly if it didn't, with an AGM coming up after a management shake-up. With M&S we have a chance to challenge a company 1) to set out a long term strategy covering the things we think really matter; but also 2) to communicate more effectively with its shareholders, and 3) to make its long term plans credible by not giving the wrong sorts of financial incentives to its executives. And for once, in this case, we believe there's interest in the public at large, and that the board will want to listen.

And it's vital for M&S that it doesn't all get forgotten after the AGM. Contributions after that date will be just as welcome as before.

This situation has prompted us to set down very quickly some of the thinking that we have developed in over ten years of discussion and campaigning on behalf of private shareholders, and this document is the result. It should not be regarded as a final word on anything, but as an opportunity for anyone who wishes to express an opinion to contribute to the debate.”

Who are we?

The UK Shareholders Association is a voluntary organisation set up to represent and promote the interests of private shareholders, and is funded solely from members' subscriptions. We aim to enable private investors to behave like owners, and generally try to work with company managements. We are not authorised to give investment advice. Members join UKSA for a variety of reasons. There is a great opportunity for investors to contribute time and ideas to our various campaigns, and to shape our agenda. There is also an extensive programme of investment-related meetings and discussions throughout the country, including visits to selected companies. The UKSA network covers the whole of the UK.

Being independent, UKSA can say what it likes (within legal limits) without worrying who it offends.

We frequently hear that private shareholders are irrelevant to most companies, having only a small proportion of the votes. We strongly believe this is a misguided view, for a number of reasons. We are real owners of our shares, as opposed to the institutions who are looking after other people's money. Private shareholders are often long-term holders, and some take a real interest in the companies in which they invest. Unlike many institutions, we are not concerned about the quarter-by-quarter performance of our holdings. However, we do note with concern the trend towards nominee holdings, which has effectively disenfranchised many individual shareholders, as they no longer receive as of right and at no expense communications from the companies in which they invest.

Further information on UKSA is available from our web site www.uksa.org.uk.

Marks & Spencer: A challenge to management and an invitation to the public to contribute to the debate

We challenge the new Marks & Spencer management:

- To set out a long term plan;
- To undertake to communicate with, and listen to, their private investors in future; and
- To show long term commitment where it counts - in the pocket.

We invite shareholders and others wishing to contribute to the discussion to write to us by e-mail.

^{*} This paper should not be thought of yet as official UKSA policy in every detail. It almost certainly reflects a majority view. Different shareholders will put different emphasis on the various competing issues. The words "we believe" and similar should be read bearing this in mind. But we hope our focus on long-term ownership will come through – on the whole, we are "proprietors" more than we are "punters", and tend to focus more on what's happening to the business than on the share price.

The rest of this paper is organised as follows:

- 1 Introduction
- 2 Challenge to M&S management
 - Set out long term strategy
 - Promise high quality communication in future
 - Show long term commitment where it counts – in the pocket
 - Basic principle of remuneration*
 - No short term incentives based on financial results*
 - Please - no share options*
 - No dilution*
 - Restricted shares to ensure proper alignment of interests.*
- 3 Questions for shareholders to ask, and strategic questions facing the company
- 4 How to join the debate

1 Introduction

Much of the background is covered in David Blundell's message on the first page. At the time of writing (June 2004), Marks & Spencer is attracting a great deal of interest. It is seen as having under-performed for a number of years, and its relatively low share price has attracted the attention of a potential acquirer. The UK Shareholders Association Limited (UKSA) is publishing this paper for the following purposes:

- To send a challenge to the new management of M&S.
- To invite shareholders and others wishing to contribute to the discussion to write to us by e-mail. (Please note: we are interested in a discussion of the issues facing M&S, and any general questions raised by this paper, not financial advice such as what is a fair price for the shares.)

One of our primary objectives in writing this paper is to improve the level of discussion between companies and shareholders. Private shareholders are not stupid. If managers have a clear understanding both of their business and of the shareholders' perspective, and take the trouble to communicate it, all sorts of benefits will follow. We have no reason to think this will not be possible in the case of M&S.

Our main points can be summarised as follows:

- a) We think that the Board is likely to say that it will take some time to turn round M&S.
- b) It's quite acceptable (and possibly correct) for the Board to ask for patience providing they communicate on the important issues now and in the future.
- c) But they **MUST NOT BE GREEDY FOR THEMSELVES**. If shareholders have to wait, as they surely will, for better dividends, the right thing is for management's interest to be **PROPERLY ALIGNED** with those of shareholders. And that doesn't mean share options. It means putting their own money into the shares and keeping it there for a large number of years. We want managers to get rich slowly with us, not get rich quickly at our expense.
- d) We've set out some of our ideas on value creation. The really important thing is to maintain, and where possible grow, the business's competitive strengths – but without wasting capital in the process. And not to dilute existing shareholders' holdings by "printing" new shares.
- e) We believe that a much more appropriate way of involving employees in quoted businesses than share options is to have an assisted share purchase scheme, whereby the company pays something towards a purchase of shares in the open market, and where the shares are held in trust for a period on behalf of the employees. But the amounts of shares offered should not be so great that less well paid employees end up with too many eggs in one basket, as has happened in the past. (Enron is a good example.)

2 The Challenge to M&S Management

Set out long term strategy

Many private shareholders will have held M&S shares for a long time. They will be interested in their company's long-term dividend-paying ability. However, in the shorter term, it may be necessary for immediate profit to take a back seat. To raise the confidence of shareholders, we invite the Board to set out a meaningful discussion of the options available to the business, sharing their current thoughts on the right long term strategy. We suggest this should cover at least the matters discussed below, and whatever else the management thinks is sufficiently important.

We don't expect all the answers immediately, but we would be disappointed if the new management could not already set out their tentative vision for the business, and the priorities for getting there, covering the next five years.

What do we mean by long term? Quite simply, we want the Chief Executive to think about the business as if it were in trust for his grandchildren. This sounds trite, but it makes the point.

We are not concerned about profits immediately, or tomorrow, but instead hope for them the day after tomorrow. We are not even too concerned about growth, but are interested in an attractive rate of return on capital in the long run, such return being achieved on the whole capital employed in the business, not simply "enhanced" by gearing. Indeed, high gearing can cause managements to take their eye off the long term ball, if the cost of financing debt begins to threaten the business in the short term. However, if opportunities occur in the future to employ capital at high rates of return, we would expect management to consider them.

Whilst we are interested in an attractive rate of return, we recognise this would be a by-product, among other things, of satisfied customers and a sustained competitive advantage. Both of these are huge challenges.

Promise high quality communication in future

We expect high quality communication, admitting not just the previous management's past mistakes but also your own mistakes going forward. This should include an appropriate level of discussion of the business's competitive strengths and weaknesses.

We believe you should try to include private investors, including share-holding employees, in dialogue, not just the institutions.

Show long-term commitment where it counts - in the pocket.

We argue against any grant of share options, but would greatly prefer restricted shares instead, held for a long period.

The Basic principle of remuneration

Executives should participate in failure as well as success. And the reward should accrue over a much longer period than two or three years. It should relate to the creation of value, not the creation of accounting results. And it should be easy to understand – one simple scheme, with a completely transparent cost.

In common with many, we would be unhappy granting remuneration packages which could be seen, after the executive leaves the job two years later, as giving egregious "rewards for failure". On the other hand, we believe shareholders should be patient for success and not expect immediate results. This is especially so in the case of Marks and Spencer, which may need to rebuild certain aspects of its operation and customer relationships.

No short term incentives based on financial results

We view long term value creation as the same thing as maximising the cash distributable to shareholders over the indefinite future, suitably discounted for the time value of money to take account of investors' opportunity costs.

We believe this is done, year by year, by a combination first of cash profits achieved in the year and, second, by an increase in what we might call economic goodwill. The second of these, which relates closely to the year on year improvement in the business's competitive strength, is much more important than the first. The two can

conflict - an example of this is raising margins so much that reputation suffers, or more competitors are tempted in.

The real problem is that the second element cannot be measured. But it is what really matters. Any remuneration system which does not pay huge attention to it is not, we believe, in the long term interests of shareholders. The board needs to exercise its best judgement to determine how to identify and reward improvements in the second element. We believe such bonus rewards should be paid in cash, should bear a reasonable relationship to basic salary, and that a large proportion of them should be invested on the executives' behalf by buying shares in the company in the open market.

Please - no share options

We are very concerned at any granting of executive share options. These do not align managers' interests with those of shareholders. On the contrary, they give an option against the main body of shareholders. They dilute the interest of the remaining body of shareholders, and they can tempt management to keep dividends low and to engineer high share prices at times when options become available to be exercised. The recent campaigns, by those bodies set up to promote or manage share option schemes, to stop accounting standards from requiring the proper recognition of the costs of share options, demonstrated a lack of integrity and a lack of respect for investors' true interests. This is clearly evidenced in the common message "If you make us account for the costs of share options properly, then we will have to stop them." As shareholders, we would rather be told about the true cost of all elements of employee remuneration and be permitted to express a view. We resent the implication that share options have been used because the cost did not have to be set out unequivocally for shareholders. (We're not complaining specifically at M&S here, but at the members of the pro-share-option campaigns.)

No dilution

We do not wish additional shares to be issued to anybody, whether through options or otherwise. All shares used in connection with executive (and any other) remuneration schemes should be bought in the open market and the cost of doing so reported as an expense at the time. As shareholders, it is per-share progress that counts for us, and increases in the number of shares almost inevitably reduce the value of our investment.

Restricted shares to ensure proper alignment of interests

We believe that the main form of participation in the company by directors and employees should be in shares, which are purchased in the market and held in trust on their behalf, thus ensuring that they can not be sold other than under the terms of the trust. Dividends on these shares would be paid to the individuals as they were declared. We would suggest that the more senior the employee, the larger the proportion of any bonuses that should be required to be invested in this way. Similarly, the more senior the employee, the longer the period should be before the shares could be sold and the proceeds given to the employee. For the most senior, we would suggest that each share purchased should be held until the earlier of 10 years after purchase, 5 years after leaving the company, or death.

(Is it too much to require this at M&S? – it would be a very powerful counter to any accusations of “short-termism”, and the main body of shareholders would be reassured that the management would be unlikely to waste the company’s capital on grandiose schemes.)

For employees apart from senior management who are interested in investing in the company's shares, we would prefer an "assisted purchase" scheme to any form of option scheme. It should be recognised that with an option scheme, the employee has no downside prior to exercising the options. But with a share purchase scheme, the employee is exposed to a fall in the value of the shares. It would not be right to encourage an employee to over-commit to the company as he or she could lose twice over if the fortunes of the company decline, with threats to both job and savings. The amounts would therefore be modest in relation to basic salary. Apart from that, the same principles would apply as under the senior executive arrangements - the shares subject to assisted purchase would be bought in the open market, held in trust, and only released to the employee after a number of years. Again, the cost of assisting with the purchase would be a cash cost, and recognised by the company as such at the time.

3 Questions for shareholders to ask themselves, to ask the company, and strategic questions – opportunities and threats facing the company

We’re looking for suggestions here, though we have set out a few specific questions which may trigger responses or further questions. Many are questions which could be asked at an AGM. If you have strong views on M&S, particularly from an employee or customer perspective, then we would be interested to hear them.

- Can M&S ever get back to its former glory, and what are the challenges to get there?
- Does “former glory” mean trusted to supply very high quality at reasonable prices, or does it mean something else? Sales volume, perhaps? How has the world changed in the last 10 years?
- If the former glory is achieved, will it be as profitable as in the past? (for example with competition like Wal-Mart, through ASDA, which is a new phenomenon in the UK)
- What is the property portfolio worth – has the character of some high streets changed so that those M&S sites are more valuable in other hands?
- What is the real situation re the pension fund? As any pension fund assessment is essentially a matter of judgement, and it is easy to be optimistic, what might the pension fund’s position be if we were to expect a downward drift in the expensiveness of equity values over the next 10 or 20 years, for example applying the view of the world held by Smithers and Co (see www.smithers.co.uk/news.shtml)
- On a ten year plus view, what, if any, businesses does it make sense to sell now?

- Should the business become more geared (e.g give cash to shareholders and borrow more) or not? Why?
- Is the current management interested in the long term, or the short term? How do we know?
- What would happen to the business in the event of a takeover?
- Is it true that M&S staff are better paid than the average on the high street. If so, is this a problem, or is the calibre of staff an important competitive advantage?
- How valuable is the experience of the most long-serving employees?
- What proportion of value added goes to the employees?
- Should shareholders take what cash they can today or, at today's price, is the upside of staying with the company for say five years better than the downside over the same period? (This is a question shareholders might ask themselves, but as we don't get involved with investment advice we don't want people to tell us their views on this one.)
- With the current level of gearing, how exposed is M&S to an economic downturn? How exposed would a bidding company be?
- Who are M&S's current loyal customers? And who are the potential loyal customers? Do people come to M&S when they get older? poorer? richer?

4 How to join the debate

Repeating the points made in David Blundell's introduction, we welcome any contributions on the issues raised in this paper to debate@uksa.org.uk. We undertake not to pass on e-mail addresses or any other personal information to anyone outside the executive of UKSA, unless people specifically request otherwise. If you would like a reply, please let us know and we will try, but we do undertake to publish in due course a summary of the contributions we receive, with possibly an interim summary before the M&S AGM. Not many people do contribute to this sort of thing; so if you do you will make a difference!

As an organisation, we're interested in constructive dialogue with companies, not in disrupting AGMs. Responses to us now should be in this same vein, please. That doesn't mean shy away from criticising, including criticism about this paper.

It will help us (though is not essential) if you could state the perspective(s) from which you are speaking, e.g. employee, ex-employee, customer, shareholder, or none of these. When we report back, we will not identify individuals. If you are a shareholder, we will be interested to know how long you owned your shares, and whether they are now in certificated or in nominee form.

As well as any points you may have on the opportunities and threats facing the business, we would be very interested to know whether you agree / disagree with the contents of our "Challenge to management" above. We aim to reflect our members' views, and to influence the views of other investors, but are also keen to take the opportunity to find out what other shareholders think.

We explained who UKSA are at the start of this paper. You can find out lots more by following www.uksa.org.uk/about.htm. We are, of course, looking for more members to participate in any of our activities, so if you think you might be interested, why not follow up any of the National or Regional contacts on the web site?

You don't have to join UKSA to send us an e-mail.

Finally, if there are any issues, quite outside the M&S debate, which you believe we should follow up, we would be interested to hear about them.

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