

Special dividends and share buybacks

Special dividends

Companies consider that special dividends provide flexibility in allowing ad-hoc returns without creating future expectations. However, some investors consider that companies opting to make regular (or annual) special dividends, are creating an expectation that this payment forms part of the recurring dividend return.

In order to help assess future dividend streams, where companies have a practice of using special dividends, investors want to understand when they will be used and their relationship to ordinary dividends. Investors are seeking disclosure of policy and practice in much the same way, as for ordinary dividends.

Share buybacks

Investors highlight that many companies have sought, and received from shareholders, a mandate to undertake share buybacks up to a stated level. Where companies hold such authority, investors are looking for disclosure on the role that buybacks play in the overall use of cash, and on the company's considerations in conducting the buyback.

Such disclosures include:

- information about the process the company uses to identify when it is appropriate to undertake a buyback;
- the maximum price the company is prepared to pay;
- the rate of return for any alternative investment used to determine whether to proceed with the buyback, linking it to the overall capital management framework of the company; and
- any other specific criteria such as what the board expects to achieve by the buyback.

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CASH GENERATION, SHARE BUYBACKS AND SPECIAL DIVIDENDS

CASH GENERATION

Over the last year we generated £363m of surplus cash after capex, interest, ordinary dividends and tax. We returned £361m of this to shareholders, through special dividends of £223m and share buybacks of £138m.

We expect to generate around £360m surplus cash in the year ahead and, again, we intend to return this to shareholders. We paid a £74m special dividend in February and have committed to a further £90m which will be paid in May. If our share price remains above our maximum limit for buybacks and our profit expectations remain unchanged, then we intend to pay further quarterly special dividends in August and November this year.

SHARE BUYBACK LIMIT GOING FORWARD

We have, on several occasions, set out the criteria by which we would decide the maximum price the Company would pay to buy back shares. We use the concept of Equivalent Rate of Return (ERR). This is the pre-tax return required from an alternative investment, if that investment were to produce the same level of earnings enhancement as the proposed buyback. We set the minimum ERR at 8%, which we consider a reasonable target for a return on equity investments.

For the year to January 2016, the mid-point of our guidance for profit before tax is £810m. On this basis an 8% ERR gives a new upper limit for buybacks of **£68.27**.

Investors consider that Next provides a good example of disclosure that identifies the:

- capital management context;
- expectations of future surplus cash generation;
- relationship between share buybacks and special dividends; and
- criteria for share buybacks, including an upper limit price and how it is determined.

When a company has undertaken a buyback, investors are looking for detailed disclosures to help understand the impact of the buyback and assess whether it was ultimately in the best interests of shareholders.

Information for each buyback transaction is available in stock exchange announcements, press releases, etc.

However, investors want to see aggregated information on buybacks in the context of capital management, in order to understand the impact of the programme on the company, and on the investor's individual holding.

Aspects of disclosure include:

- weighted average cost of the shares bought;
- overall cost to the company; and
- impact on key metrics such as earnings per share.

Investors consider that the interaction between buybacks and management performance metrics (and therefore directors' remuneration) also needs to be made clear.

Some investors would also like disclosure of the board's view on the overall success of the buyback, to support reporting on company stewardship. Retail investors, in particular, want boards to explain their assessment of the benefit of the buyback programme undertaken.