Shareholder Value Illustrated

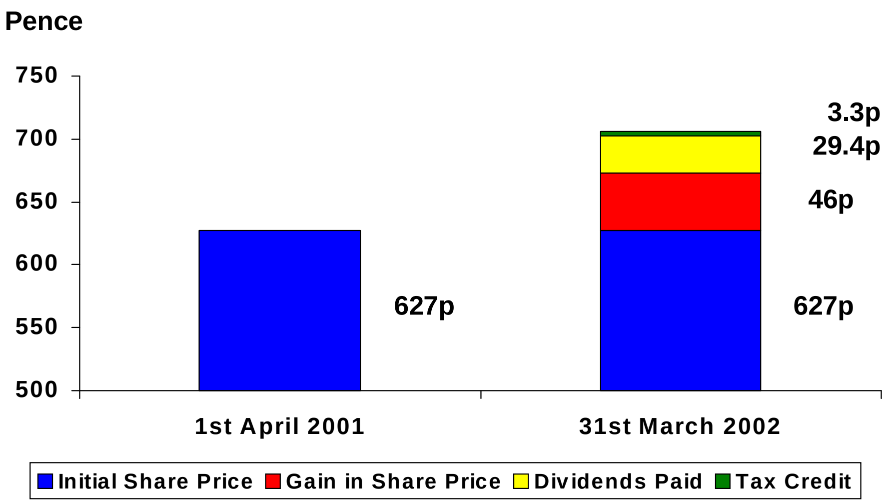
<u>Shareholder Value Illustrated – Boots plc</u>

Boots plc was one of the first UK companies to adopt the principles of managing for shareholder value in 1990. Boots' 2002 Annual Report & Accounts states:

'At Boots, we have a single overriding management objective that shareholders will get the best possible return on their investment in Boots over time, through dividend payments and share price increases. The maximisation of cash flow over time is the key factor in value creation.''

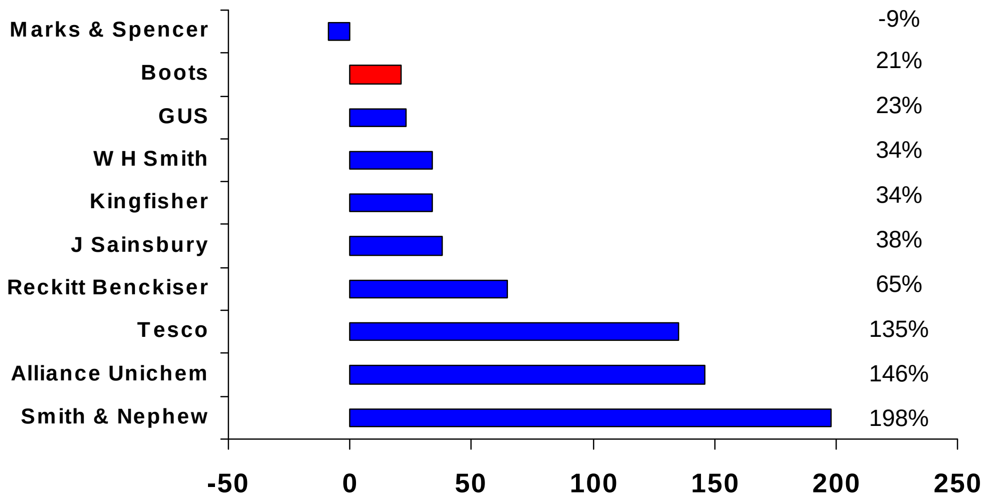
Boots Total Shareholder Returns (TSR)

The key measure used by Boots to measure its shareholder value performance is Total Shareholder Returns (TSR). Boots share price on 1st April 2000 was £6.27, and by 31st March 2002, it had risen to £6.73. For the year ending 31st March 2002, Boots declared a net dividend of 29.4p per share, which was worth 32.7p to shareholders due to the Inland Revenue's 1/9th tax credit on dividends paid. Boots, therefore, delivered a TSR of 12.6% for the year ending 31st March 2002. This was made up of 46p (7.3%) from share price appreciation (capital gains) and 32.7p (5.2%) from dividends (income). This level of TSR would have exceeded Boots' shareholders minimum expectations. Boots, therefore, created shareholder value during the year to 31st March 2002.



Boots Relative TSR Performance

Boots monitors its TSR performance against a peer group of 10 other companies[1] on a rolling five year basis. Over the five years to 31st March 2002, Boots' TSR performance was 21% and well below Smith & Nephew which delivered a TSR of 198% over the same period. Boots' five year TSR equates to an annual compound return of just under 4% per annum compared to Smith & Nephew's annual compound return of nearly 15%. Over the five years, Boots produced a return that was less than the risk-free return investors could have received from UK government bonds. This level of return would have disappointed shareholders, falling well below their minimum expectations. Boots has, therefore, destroyed shareholder value during this five year period.

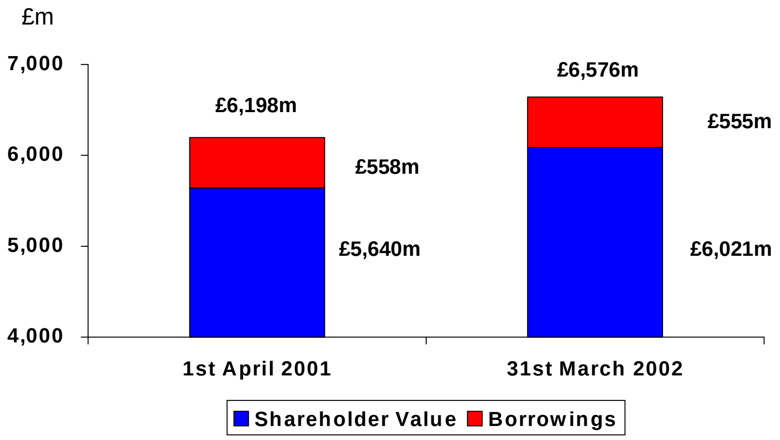


5 years to 31st March 2002

[1]Debenhams is also amongst Boots' peer group, but as Debenhams has been listed for less than five years, a five year TSR is not yet available to compare

Boots' Economic Value & Shareholder Value

The total value economic value of Boots as of 31st March 2002 was £6,576m, comprising its market capitalisation (stock market perspective of shareholder value) of £6,021m (894.6m shares times £6.73 per share) and £555m of borrowings. During the year, Boots' economic value increased by £378m ((£6,576m minus £6,198m) and Boots' shareholder value increased by £381m (£6,021m minus £5,640m).



Source: Boots Annual Report & Accounts 2002

Boots' Free Cash Flow

For the year ending 31st March 2002, Boots generated a free cash flow of £485m:

	£m	£m
Cash flow from operating activities		
Cash flow from operating activities before tax	722	
Taxes paid	(139)	
Cash flow from operating activities after tax		583
Cash flow from investing activities		
Purchase/sale of fixed assets	(102)	
Acquisitions/disposals	4	
Cash flow from investing activities		(98)
Free cash flow		**485**

Boots' free cash flow for the year ending 31st March 2002 was £426m higher than for the year ending 31st March 2001. This was largely the result of the £237m invested in acquiring the Clearasil brand in October 2000 during the previous financial year. This demonstrates that free cash flow can be a volatile measure, and one that is often more volatile than accounting profit.

Boots' economic value of £6,576m when combined with its weighted average cost of capital (WACC) of 8.5%[2] is equivalent to a perpetual free cash flow of £559m. This is higher than the free cash flow generated by Boots in any of the previous five years.

[2] Source: Boots Annual Report & Accounts, 2001

Boots' Economic Profit

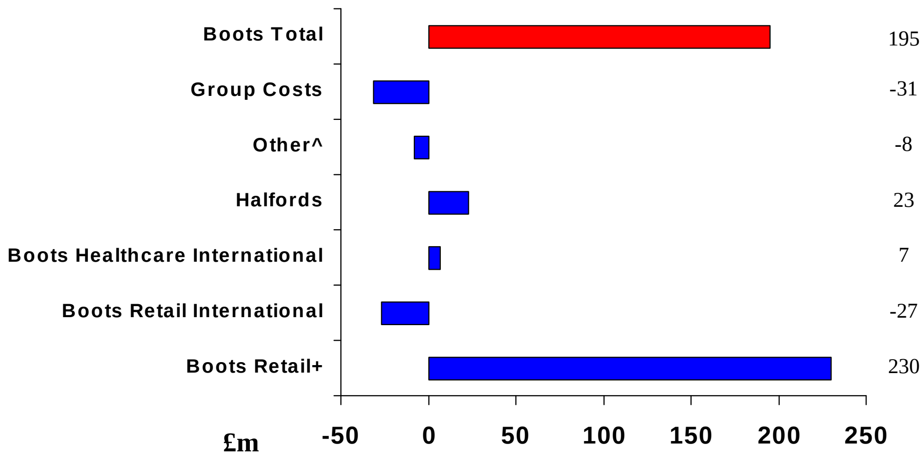
Economic profit measures the surplus earned by a company after the deduction of all its operating costs including its liability to pay tax and the opportunity cost of the capital employed in the company. The calculation of economic profit for Boots for the year ending 31st March 2002 is:

Operating profit before tax	£583m
Tax liability (£583m x 30% tax rate)	(£175m)[3]
Charge on capital employed*	(£213m)
Economic profit	£195m

*Average capital employed x WACC = £2,505m x 8.5%[2]

[2] Source: Boots Annual Report & Accounts, 2001
[3] Tax on operating profits (£175m) for the year ending 31st March 2002 will differ from actual cash taxes paid (£139m) during the year because of timing and a number of other factors

Economic profit can also be measured at the business unit level and is summarised below for the year ending 31st March 2002:



+Boots The Chemist, bootsphoto.com, Boots Wellbeing Services including Boots Opticians
^ Boots Properties, Boots Contract Manufacturing & Boots share of handbag.com joint venture

Source: Boots Annual Report & Accounts 2002

During this year, Boots Retail (predominately Boots The Chemist) contributed 118% of the total Boots group economic profit. This situation, where economic profit is concentrated in one business unit, is not unusual to Boots. Many companies using economic profit often find that several of its business units are producing a negative economic profit. It is important, however, to remember that economic profit, as with any other single period measure, does not capture long-term value creation potential, and business units currently producing negative economic profits may well be capable of delivering positive economic profits in the future. Indeed, the economic value of a company, or a business unit or a brand is the summation of the capital employed plus total flow of future expected economic profits discounted by the company's weighted average cost of capital (WACC). It is the total discounted flow that determines value rather than any single year.

Shareholder Value – The Three Perspectives

There are three main perspectives on the value of a company that is attributable to its shareholders ie shareholder value. These are: -

1. The balance sheet perspective
2. The stock market perspective
3. The economics perspective

The balance sheet perspective of shareholder value is the book value of 'shareholder funds'. On 31st March 2002, Boots' balance sheet shows shareholder funds of £2,018m. Because the balance sheet is drawn up on the basis of historic cost accounting, shareholder funds on the balance sheet typically understates the value of the company attributable to its shareholders and often by several multiples.

The stock market perspective of shareholder value is simply a company's market capitalisation i.e. the number of shares in issue times the share price. On 31st March 2002, Boots had 894.6m shares in issue trading at £6.73 per share. Therefore, the stock market measure of Boots' shareholder value, i.e. Boots market capitalisation, was £6,021m. This was 3.0 times the balance sheet value of Boots shareholder funds. This ratio of market capitalisation to shareholder funds is called the market to book ratio.

The economic perspective of shareholder value can be derived in two ways:

1. The summation of a company's future expected free cash flows discounted by weighted average cost of capital, minus its borrowings

2. The summation of a company's capital employed plus the total flow of future expected economic profits discounted by the company's weighted average cost of capital (WACC), minus its borrowings

Assuming capital markets function efficiently, the economics perspective and stock market perspective of shareholder value should equate in the long-term.

For the year ending 31st March 2002, Boots produced a free cash flow of £485m and an economic profit of £195m. Boots market capitalisation of £6,021m on 31st March 2002 is equivalent to Boots producing a perpetual free cash flow of £559m or a perpetual economic profit of £387m. In valuing Boots' shares at £6.73, the stock market is implicitly taking the view that Boots' future performance will be better than its current performance.

A version of this article first appeared in Mentor Journal (Spring 2002)

For further information, contact Paul New at Compete to win on +44(0)20 8390 9972 or by email at paul.new@competetowin.co.uk