see money differently

NEDGROUP INVESTMENTS GLOBAL EQUITY FUND

Quarter One, 2018

For the period ended 31 March 2018

Long-termism

The aim of investment must be to achieve the highest possible post-tax return on capital invested at the lowest possible risk. There are many investment strategies that claim to do this but very few have proven to be successful over numerous investment cycles. Value investing (including deep value and other value investing styles), momentum investing and quality investing are three that have proven long-term success. The Veritas Global team are adherents of both quality investing and value investing at the same time, aiming to buy companies with substantial competitive advantages (i.e. quality) when they are available at attractive valuations. We employ this investment style in two strategies, the Veritas Global Equity Income strategy which places more emphasis on value (through the lens of dividend yield based investing) and the Veritas Global Focus strategy which seeks quality companies (regardless of dividend yield) but only invests in them when we assess their valuation to be attractive on a long-term basis. Following such a strategy requires three fundamental skills:

- Good analysis – Being able to identify the attributes of quality companies and reasonably assess their long-term evolution (will they still be high-quality companies in 10 years' time?). This analysis requires a deep understanding of an industry and the companies within the industry together with the ability to assess the risks and opportunities facing the industry and its constituents.

- Valuation Discipline – understanding the approximate intrinsic value of these quality companies and only investing when they are attractively valued by the market. At Veritas we focus on absolute value ("intrinsic value") rather than relative value and aim to determine the prospective rate of return we should achieve over a sensible holding period (typically 5+ years).

- Long-term outlook – The nature of buying good companies largely means that the investment outcome relies to some degree on the compounding of earnings and cash flows which takes time. Daily fluctuations in share prices based on news flow are rarely relevant to long-term investors except insofar as it may offer an entry point. The ability to invest for the long term and ignore short term "noise" is largely a behavioural point and while easy to include in any "process" is much more difficult to implement in practice.

Numerous studies show that humans are risk averse and as a consequence feel more pain from losses than pleasure from gains on a scale of around 2:1. The more frequently a portfolio is checked the more likely it is that it will show a loss. The impact of this is not just emotional, however – humans have evolved to try to minimise pain. If an inexperienced investor frequently sees losses on their portfolio it is highly likely that they will do something to try and reduce these losses.

As a consequence of this, we recommend that our investors assess investment results over at least 5-year cycles and ideally longer (7-10 years) or better yet, a full economic cycle (although monetary policy post the financial crisis has largely made a mockery of the traditional economic cycle).

Consistent outperformance over 5-10 year cycles (including both bull and bear markets) is more likely to indicate some repeatable skill than assessing annual performance. Since 1 January 2006, the Veritas Global Focus Fund (USD A) has delivered a total return of 177% which can be compared with 111% for the MSCI Global Index and places the fund in the top decile of global funds in the IA Global sector. However, if we look at our performance monthly, the fund outperformed the index in only 56% of months and underperformed in the other 44% - little better than a coin toss.

Given the way that we manage money, we strongly believe that it is important to be macro-economic aware but we spend no time trying to forecast macroeconomic factors. This means we try to understand the economic environment we are in but don't invest based on an assessment of what might happen economically. Consequently, we do not attempt to forecast rates of GDP growth or other factors such as future interest rates. Indeed, even if we knew these it is unlikely we could consistently profit from that knowledge as we would also need to know what other market participants expected. Currently (as always?) there are a number of positive and negative factors: economic growth is reasonable in most significant countries; inflation seems to be rising but generally within normal bounds; tax cuts in the US are positive; rising protectionism is negative; Brexit is negative for Europe; debt levels are elevated; asset valuations are reasonably high; rising interest rates and Quantitative Tightening are both negative.

Rather than attempt to forecast the impossible in terms of macroeconomic variables, we concentrate on searching for opportunities to invest for the long term in high-quality companies when they are attractively valued. Given the prolonged bull market we have experienced over the last 9 years and particularly the increasing trend to invest in "quality" companies it has become harder to find attractively valued opportunities.

Consequently, we have more recently found opportunities to buy when others are selling due to short-term concerns. Sometimes these concerns are macroeconomic (interest rate rises have severely hit the valuation of companies seen as "bond proxies") and sometimes the concerns are more specific (Facebook for example). What does seem clear is that since the start of 2018 the investment horizon of market participants has shortened with investment decisions now on a hair trigger setting and consequently volatility has markedly risen.

The "narrative" market

The impact of rising "short-termism" is that many investors are focusing much less on the operational fundamentals of companies and much more on the investment "narrative". Companies benefitting from a strong "narrative" are performing well almost regardless of their underlying operational performance and those companies suffering from a more difficult "narrative" are performing poorly regardless of operational performance. Over time, the operational and fundamental performance will be the arbiter of valuation and therefore long-term return, not the "story". Examples of this within our holdings include:

CVS - This US pharmacy and purchasing benefits manager has been a long-term holding for Veritas. The company is extremely well placed in the US Healthcare market, with more retail pharmacies than any other company and one of the top two purchasing benefits managers in the United States. Over the past 5 years, the company had grown adjusted earnings per share by 11% annually and free cash flow in 2017 was $6.4bn. Growth over the next 5 years is likely to be slightly slower with compound growth in EPS and FCF of around 8% expected. This growth rate, however, would be exceeded should CVS's proposed merger with Aetna proceed. Such a merger would create a vertically integrated healthcare behemoth with the attendant scale and opportunities that would create. One example would be utilising CVS's c.10 000 stores to provide more front-line health care services at lower cost. On this note, CVS recently announced that they are expanding into chronic kidney disease detection, treatment and dialysis, which is a major cost for health insurers.

Even without the Aetna acquisition, CVS looks extremely attractively valued with a FCF yield over 11% and a 2018 PE ratio of only 9.6x. This lowly valuation has come about because the share price has fallen, not as a consequence of lower earnings or forecast earnings but instead because the valuation multiple has contracted as investors have increasingly come to fear both Amazon entering the healthcare market and the political focus on high drug costs in the US.

This "narrative" is clearly negative to the share price of CVS with the shares falling from over $83 in January to the current price of $61.50, a decline of 26%. The reality seems somewhat different. We have previously written about how difficult it will be for Amazon to gain traction in the US prescription drug market and while US drug prices are high (relative to other countries) this is primarily a consequence of pharmaceutical company pricing decisions rather than the PBM's or the pharmacies that dispense these drugs. The current narrative of intermediaries in the supply chain being to blame for high prices is being strongly supported by the large and powerful pharmaceutical lobby. However, the reality is that the intermediaries operate on a very low margin and even if they were removed entirely from the supply chain, drug prices would fall less than 10% and more likely would increase as the intermediaries no longer exerted pressure on the pharmaceutical companies to hold down prices through the use of formularies and competition.

If there were a general decline in drug prices (which we consider unlikely given the power of the pharmaceutical lobby), the PBM's would very possibly see some impact but it is unlikely that pharmacies would suffer much as the cost to physically dispense a drug would not change with the price of the drug.

Even within the PBM's, given the increasing proportion of high priced "specialty" drugs increasingly prescribed by doctors, it is unclear whether a general decline in drug prices would make a significant difference to PBM earnings given the changing mix. Overall we consider CVS remains a good quality company with a sizeable moat which will only be increased should the merger with Aetna be approved. The current valuation does not reflect this and instead is impacted by short-term conjecture (especially with regards to Amazon). It may take years for CVS to demonstrate the strength of its position relative to Amazon (it is difficult to prove anything against a mythical competitor) so it is possible that the valuation remains low for a period but we believe it will, in time, recover to reflect the quality of business that CVS is. This would simplistically result in around a 50% increase in price, which together with the compounding of earnings over the intervening period, should deliver very attractive returns to the fund.

Ørsted - at the other end of the narrative spectrum the fund has a stake in the Danish wind power company, Ørsted. This company was previously called Dong Energy and was primarily a traditional oil and gas exploration and production company. Under new management, the company decided to exit oil and gas and focus on renewable energy, in the process becoming the world's largest offshore wind power generator.

Being early in the development of large offshore wind farms gave Ørsted a significant advantage in terms of both government subsidies and the development of expertise (effectively the expertise was subsidised by Governments). As a consequence, the costs of wind farm projects have come down much more rapidly than even industry experts expected. However, Ørsted still retains the large subsidies (often for up to 20 years) on the projects it has been contracted for (many of which are still under construction and therefore benefiting from the lower costs). This has led to a large increase in the value of each of these wind farms that was not reflected in the valuation of Ørsted when we entered the position in 2017.

This narrative is now well known and the valuation of Ørsted now reflects the "supernormal" value of the contracts it has won with the share price having increased around 50% since our purchase last year despite earnings that have been in line with our expectations at the time. This increase in valuation not only reflects the value of contracts won but also partially reflects the value of contracts the company is yet to win (in particular in Taiwan and the US) indicating just how much the "narrative" on Ørsted has changed over our holding period of around a year. While we (with others) believe that the company is well placed to win some of these large new contracts as a result of their expertise and track record, it is clear that the valuation is now more speculative than at purchase.

The Taiwanese project, however, could be a significant source of further "supernormal" profits and it is clear that only a fraction of this value is currently priced into the shares such that on a risk-adjusted basis we continue to believe they are an attractive investment.

Longer term perspective

Over the past five years our performance has been largely in-line with the MSCI World Index and somewhat ahead of our absolute target of OECD G7 CPI+6% annually. While the same is also true over the past 3 years, the last year has been more difficult in terms of performance relative to an equity index. This result, while disappointing in the short term, seems exacerbated by the poor share price performance of a number of holdings that are suffering from a negative "narrative" but operational performance remains on track. Over time we would anticipate that the value from these positions will be realised for the fund and our investors.

The portfolio underperformed the index over the three month to end March. Turning first to the detractors:

Capita had another bad quarter after the company announced, under new CEO Jonathan Lewis, that profits would be closer to £300m than the £400m expected, it would be suspending its dividend, embarking on a programme of asset sales and planning a rights issue to raise up to £700m. We have met with Jonathan Lewis twice and believe he has identified the problems with the business and the measures taken, whilst aggressive, are the right ones. He has concluded that the company has become too complex making it difficult to maintain a competitive edge in all its businesses and it's been driven by short term focus and lacked financial discipline in acquisitions made in the last few years. Clearly the negative press backdrop in light of the demise of Carillion is not helpful despite Capita not operating in similar areas, having £1bn in cash and higher profit margins. Unfortunately until the details of the rights issue are announced, the stock will remain supressed. We now know there will be an announcement of a five-year turnaround plan including the rights issue details on the 26 April. Capita is the concern stock in the portfolio and one we clearly should have sold. We do however believe the company is worth more than the distressed levels it has been trading at.

Capita aside, most of the stocks that fell over the quarter seem to be driven by short term sentiment. Indeed they are largely not sensitive to global trade concerns and are huge beneficiaries of US tax reform. These included the two US Cable companies, **Charter Communications** and **Comcast** and the Purchasing Benefits Manager (PBM)/ retail pharmacy **CVS Health**.

In the case of the US cable companies there is continuing concerns over cord cutting despite the pickup in video subscribers in the last reported quarter. It's true that over 12 months Charter has seen a drop of 1.7% in the number of residential video subscribers but revenues still rose 3% over the period due to higher priced bundles that includes fast broadband needed to access YouTube, Netflix and other Over The Top (OTT) services. Charter is in the process of setting up a wireless service for its customers. This will use the Verizon cell network and Charters Wi-Fi hotspots. This will enable the company to offer a further service to its bundle. Given the number of moving parts with delivery of entertainment, 5G and potential consolidation, investors are not focussing on the free cash flow that the US cable companies are generating.

Comcast has already set up a mobile service, also using the Verizon network. After the first 7 months it had attracted nearly 400K subscribers. Like Charter, Comcast suffers from the same perceived headwinds of cord cutting.

However it also owns the NBC Universal business which includes TV, film and theme parks so is more diversified. The concern over the quarter was the rationale and price Comcast offered to acquire Sky. Initially 21st Century Fox had bid for the 60% of Sky it does not own. Then Walt Disney launched its own attempt to buy Fox and in so doing pick up Sky. Comcast then bids for Sky at a price 16% higher than the Fox offer but for 50% + one share of the company, valuing it at $31bn and costing Comcast $15.5bn in cash. Whilst there is no denying that the addition of Sky would diversify Comcast's portfolio (it would raise the international share of revenue from 9% to 25%) and double its scale, it exposures the company to Satellite TV which faces secular pressures and significantly increases leverage (the company has about $3.4bn in cash on the balance sheet). Whilst there may be limited downside given valuation and FCF generation a bidding war that inflates the value of Sky further would not be positive. We have spoken and written to the company to express our views that Comcast should not overpay and preferably use the cash to buy back its undervalued shares.

CVS Health shares initially rose strongly on the back of earnings and revenue in Q4 that beat guidance. The company has had a good selling season winning over $6bn of PBM business and also stated that recent tax reform boosts cash flow by about $1.2bn.

The company has highlighted it would use some of the cash to pay down debt and some to make strategic investments. The company has revised down its operating growth guidance for 2018 on the basis of making further investments and suspending its share buyback program which cause the stock to fall back. In the market selloff investors appear to have returned to worrying about the consolidation risks behind CVS buying Aetna (Aetna costing $69bn is approx. the same as the market cap of CVS Health). The longer term benefits of moving towards a more integrated health company is positive. CVS will be able to put its footprint of pharmacies to better use taking pressure of hospitals e.g. they recently announced they will offer kidney dialysis services. Many people go undiagnosed until too late. Such a service will help reduce longer term costs.

US President Donald Trump blocked a hostile bid by Singapore-based Broadcom to take over smartphone chip maker **Qualcomm**, citing security concerns. Trump claimed there was credible evidence that such a deal 'threatens to impair the national security of the US'. The order came despite assurances from Broadcom it would relocate back to the US by early April ahead of a previously planned Qualcomm shareholder vote on the deal.

Qualcomm had tried to find ways to prevent the deal including asking the Committee on Foreign Investment in the US to look into national security implications of the merger. We heavily engaged with the company over the quarter given its unwillingness to act in the interests of its shareholders by at least talking to Broadcom when initially approached. Qualcomm postponed its annual shareholders meeting after secretly requesting the national security review and thus prevented the backing of Broadcom candidates to the Board. (This is covered in detail under the ESG section). Qualcomm itself had already bid for NXP Semiconductor but this now relies on the Chinese. It has obtained eight out of the nine necessary antitrust approvals for the deal to take place. Only China remains. Given tariff trade spat between the US and China, this approval may not take place. Given NXP are the world leader in automotive chips it compliments Qualcomm's focus on smartphones.

Dentsply Sirona, the world's largest manufacturer of professional dental products and technologies, fell despite revenue/earnings ahead of expectations for Q4. The company has delivered lower merger synergies than the company had estimated when Dentsply and Sirona merged in Feb 2016. It also took an impairment charge during Q4 17 in relation to merger synergies. Margins in 2018 are expected to be impacted by tax reform. The company generates 35% of its revenue from the US and the rest from international markets.

The tax reforms are expected to reduce the company's foreign tax credit as well as its ability to defer tax on foreign income. The company has made some leadership changes including appointing a new CEO who have announced a significant strategic growth plan that will see the company leverage off its EM presence and its superior technological offerings. The company is best in class and exposed to the tailwinds of ageing population and dental health.

Turning to the positive contributors over the quarter:

Ørsted, the Danish renewable energy company whose prime business is in wind power, performed well over the quarter. The company delivered positive Free Cash Flow for the year against guidance at the beginning of 2017 of expected negative FCF during the year. This was due to high divestment proceeds. Ørsted sold the oil and gas division and achieved higher than expected cash from two farmdowns of Borkum Riffgrund and Walney Extension wind farms (a farm down is the term given to selling typically a 50% stake in the wind farm to release funds for future investment). The company is also positive about the future. There is the expected farm down of Hornsea 1, a large UK wind farm and further improvement in capex efficiency. The company has also committed to significantly increasing the payout ratio should it not be successful in achieving new wind farm projects by applying its price discipline.

In such a case, the proceeds from farm downs and further operational efficiencies (costs are coming down all the time) will deliver a strong excess cash position. That said there is the prospect that Ørsted could be successful in the emerging wind farm projects in both Taiwan and the US. The company is part way through receiving environmental approval from the Environmental Protection Administration in Taiwan for a wind farm project off the coast of Changhua in Taiwan.

Rolls-Royce shares announced a 25% increase in annual profits and intentions to further streamline the staff structure further reducing costs. Warren East, CEO has already eliminated 600 senior manager positions in the Roll's main aerospace business and in its marine business arm, which may be sold. Pre-tax profits surged to just over £1bn in 2017 whilst free cash flow more than doubled to £270m. The company is well on its way to achieving its target of £1bn of free cash flow by 2020. Under East, the company has turned a £4.6bn annual loss to a £4.9bn operating profit. The companies 5 divisions have been streamlined down to 3: civil aerospace, defence and power systems. Rolls expects aircraft engine sales to rise from 4400 to 6000 over the next 5 years.

After a tumultuous period in which Chairman, Donald Brydon survived a shareholder vote to have him step down after he dismissed long standing CEO Xavier Rolet, the shares in LSE performed well as the company continues to grow across all its main businesses, namely Information Services, Post Trade and Capital Markets. Revenue rose 17% to £1.8bn with particularly strong performances in the FTSE Russell index and derivatives clearing businesses. The company is making progress in its recruitment for a new CEO and is proactively engaging with Veritas. We are pleased that Brydon will stepping down as Chairman next year given his conflicted position of holding several Chairmanship roles. The company does remain vulnerable to take-over by another (most likely US) exchange.

Thermo Fisher reported a 22% rise in Q4 revenues which was better than expected and the company grew across all its main divisions, Life Sciences, Analytical Instruments, Speciality diagnostics and Lab Products and Services. Among the company's Life Sciences business, Next Generation Sequencing NGS (gene sequencing) represents 2% of total revenues and is growing. The company announced an agreement with market leader in NGS, Illumina to allow the later to sell its best in class AmpliSeq technology for its sequencing platforms. This technology is highly effective in capturing DNA and RNA from minute amounts of samples for application in multiple areas of research. As medicine moves more toward targeted solutions a standardisation in gene sequencing is seen as highly beneficial.

Relative attribution by region: 3 months to 31 March 2018

Region	Portfolio Average Weight	Portfolio Total Return	Portfolio Absolute Contribution	Index Average Weight	Index Total Return	Index Absolute Contribution	Relative Attribution Analysis Allocation Effect	Selection Effect	Total Effect
Asia/Pacific Ex Japan	6.9	-2.0	-0.0	4.4	-3.7	-0.2	-0.0	0.2	0.1
Japan	–	–	–	9.0	0.8	0.0	-0.2	–	-0.2
North America	55.2	-5.4	-3.1	63.0	-1.1	-0.6	-0.0	-2.4	-2.4
United Kingdom	8.8	-7.5	-0.6	6.4	-3.9	-0.2	-0.1	-0.3	-0.4
Africa/Mideast	2.0	-4.1	-0.1	0.2	-5.3	-0.0	-0.1	0.0	-0.1
Europe ex UK	14.0	10.2	1.3	17.0	-1.2	-0.2	0.0	1.5	1.5
Cash and equivalents	13.1	n/a	0.0	–	–	–	0.1	–	0.1
Total	100.0	-2.5	-2.5	100.0	-1.3	-1.3	-0.2	-1.0	-1.2

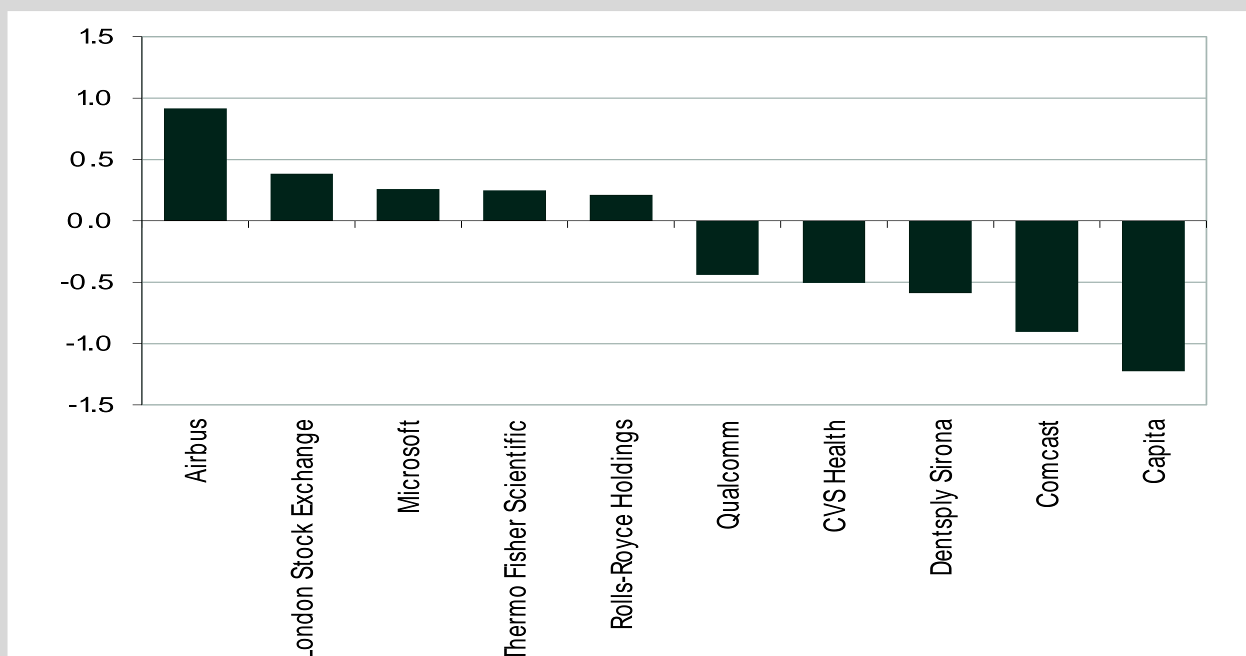
Relative attribution by sector: 3 months to 31 March 2018

Sector	Portfolio Average Weight	Portfolio Total Return	Portfolio Absolute Contribution	Index Average Weight	Index Total Return	Index Absolute Contribution	Relative Attribution Analysis Allocation Effect	Selection Effect	Total Effect
Consumer Discretionary	10.7	-11.8	-1.2	12.6	1.8	0.2	-0.0	-1.4	-1.5
Consumer Staples	3.8	-12.8	-0.4	8.7	-5.3	-0.4	0.2	-0.3	-0.0
Energy	–	–	–	6.1	-5.4	-0.3	0.2	–	0.2
Financials	9.2	1.3	0.1	18.2	-1.9	-0.4	0.1	0.3	0.4
Health Care	25.0	-2.1	-0.6	11.8	-1.2	-0.1	0.0	-0.2	-0.2
Industrials	15.9	-0.9	-0.1	11.7	-1.6	-0.2	-0.0	0.1	0.1
Information Technology	19.1	-2.6	-0.5	17.4	3.4	0.5	0.1	-1.1	-1.0
Materials	–	–	–	5.2	-4.5	-0.2	0.2	–	0.2
Telecommunication Services	1.5	0.5	-0.0	2.7	-5.9	-0.2	0.1	0.1	0.1
Utilities	1.6	20.4	0.3	2.8	-1.7	-0.0	0.0	0.3	0.3
Real Estate	–	–	–	2.9	-3.8	-0.1	0.1	–	0.1
Cash and equivalents	13.1	n/a	0.0	–	–	–	0.1	–	0.1
Total	100.0	-2.5	-2.5	100.0	-1.3	-1.3	1.0	-2.2	-1.2

Relative attribution by security: 3 months to 31 March 2018

Holding	Portfolio Average Weight	Portfolio Total Return	Portfolio Absolute Contribution	Index Average Weight	Index Total Return	Index Absolute Contribution	Attribution Total Effect
Top 5 relative stock contributors							
Airbus	5.7	15.7	0.9	0.2	15.7	0.0	1.0
London Stock Exchange	3.7	12.8	0.4	0.0	12.8	0.0	0.5
Thermo Fisher Scientific	3.5	8.8	0.2	0.2	8.8	0.0	0.3
Rolls-Royce Holdings	3.7	6.7	0.2	0.0	6.7	0.0	0.3
Microsoft	4.2	7.2	0.3	1.6	7.0	0.1	0.2
Bottom 5 relative stock contributors							
Capita	1.4	-62.7	-1.2	0.0	-62.7	-0.0	-1.3
Comcast	6.5	-14.5	-0.9	0.4	-14.5	-0.1	-0.8
Dentsply Sirona	2.3	-23.6	-0.6	0.0	-23.5	-0.0	-0.5
CVS Health	3.7	-13.8	-0.5	0.2	-13.8	-0.0	-0.4
Qualcomm	3.7	-12.5	-0.4	0.2	-12.9	-0.0	-0.4

Key stocks driving portfolio results



Commentary on two significant stocks in your portfolio

Airbus
+ 15.7% in USD
(Industrials, France)

Good results which were well above expectations led to the share price rising. In particular cash generation has been strong and is forecast to continue which has been taken positively by the market. Robust free cash flow growth has been at the core of our investment thesis for Airbus since we initiated the position and is clearly now coming to fruition.

Capita
- 62.7% in USD
(Industrials, United Kingdom)

The new CEO Jon Lewis reset expectations for the company with a shrink to grow strategy. The company will focus on technology enabled BPO which will require more investment in technology and at the same time divest non-core areas and cut costs. This was largely expected. He also announced the suspension of the dividend and a rights issue of up to £700m which appear extreme given the sale of Capita Asset Services for £880m in 2017. However, post the rights issue the company will have a strong balance sheet. We believe that the reaction of the shares is due to the uncertainty of the rights issue and restructuring hanging over the company and the share price does not current reflect intrinsic value.

Portfolio breakdown: As at 31 March 2018

Region	Portfolio %	Index %
North America	54.8	62.8
Europe ex UK	13.0	17.1
United Kingdom	11.0	6.4
Asia Pacific ex Japan	5.4	4.3
Africa and Middle East	2.0	0.2
Japan	–	9.1
Cash and equivalents	13.7	–
Total	100.0	100.0

Sector	Portfolio %	Index %
Energy	–	6.1
Materials	–	5.1
Industrials	14.7	11.6
Consumer Discretionary	9.8	12.7
Consumer Staples	5.8	8.7
Health Care	24.5	11.7
Financials	9.4	17.9
Information Technology	19.0	17.6
Telecommunication Services	1.3	2.7
Utilities	1.8	3.0
Real Estate	–	3.0
Cash and equivalents	13.7	–
Total	100.0	100.0

Currency	Portfolio %	Index %
USD	72.9	59.5
EUR	11.8	12.3
GBP	9.2	6.4
AUD	3.1	2.4
DKK	1.8	0.7
SEK	1.3	1.0
Other	0.0	17.7
Total	100.0	100.0

Top 10 portfolio holdings: As at 31 March 2018

Holding	Sector	Country	Portfolio %
Comcast	Consumer Discretionary	United States	5.9
American Express	Financials	United States	5.6
Airbus	Industrials	France	4.8
Rolls-Royce Holdings	Industrials	United Kingdom	3.9
Charter Communications	Consumer Discretionary	United States	3.9
Microsoft	Information Technology	United States	3.9
London Stock Exchange	Financials	United Kingdom	3.8
Thermo Fisher Scientific	Health Care	United States	3.5
CVS Health	Consumer Staples	United States	3.3
Qualcomm	Information Technology	United States	3.3
Total			41.9

Engagement:

Qualcomm Incorporated - Information Technology - United States

Please see below an example of company engagement which occurred during the quarter:

In November Qualcomm was the recipient of a bid from Broadcom for $104bn ($70 per share). This was a 37% premium to share price. Qualcomm refused to engage citing a material undervaluation of the business. There were also several complicating factors in the deal. The Executive Chairman of Qualcomm was Paul Jacobs whom previously held the position of CEO and his father was one of the founders of firm. However, the Jacobs family held little stock in Qualcomm. Broadcom and Qualcomm are competitors. Broadcom CEO, Hock Tan, held a view on the semiconductor market and this was materially different to that of Qualcomm. Whereas Tan believed that the industry was maturing and that cost should be meticulously managed with a narrow focus, Qualcomm did not share this view, considering themselves as an effective R&D engine. On top of these factors Qualcomm was trying to complete the $37bn takeover of semiconductor manufacturer NXP. Finally, Broadcom is currently a Singaporean based company but had the week earlier stated that it would move its domicile to the US. This meant that it could come under the scrutiny of the Committee for Foreign Investment (CFIUS) which had previously blocked deals involving China.

Given the Qualcomm response, Broadcom decided to go hostile. They raised the bid to $82 per share ($22 in Broadcom equity) and entered into a proxy fight to replace the entire Qualcomm board (11 members) at the upcoming AGM at the start of March. This was later reduced to 6 members but would still constitute a majority. During this period we had calls and meetings with both parties to assess the relative options for value creation. To stave off the threat Qualcomm announced a restructuring plan targeting a minimum of $5.25 of EPS by 2019 either by a consummation of their proposed deal to buy NXP or by a significant share buyback (up to 30% of the stock). They also suggested regulation and price were an issue to deal closure. During further work we had identified that these regulatory factors could be manageable and Broadcom had made a deal more palatable for investors by increasing the amount offered in Broadcom equity. During this process we did take a more aggressive stance with the Qualcomm management team to encourage some form of engagement with Broadcom over a potential deal, including writing to the board and having calls with management. The companies did then meet to discuss the proposal on February 14th, but again it appeared superficial.

We maintained our engagement with Qualcomm throughout the period when they renegotiated the terms of the NXP deal and showed limited willingness to engage with Broadcom. Within the final week before the AGM the Qualcomm management team did begin to become more agreeable to a solution given the feedback that investors had given them. At this point it also became apparent that Qualcomm had in late January made their concerns known to CFIUS that a deal could damage the national interest. Whilst CFIUS would not be in a position to scuttle the deal if Broadcom was US based it could whilst it was a foreign entity. CFIUS duly made Qualcomm delay the AGM. Broadcom brought forward their re-domiciling and CFIUS passed it to the Office of the President whom vetoed the deal.

In the days before the original March AGM we had a call with Qualcomm management decided to vote the blue (Broadcom) proxy partly in line with the ISS recommendation. Given the Trump intervention the vote was effectively made null and void. However, ISS suggested continuing to vote the blue card to make clear investor dissatisfaction. At this point Paul Jacobs announced that he may look to take the company private and was duly removed from the board. Jeff Henderson was then made Non-Executive Chairman.

We had a meeting with Jeff Henderson in between the moved AGM dates. During that meeting we discussed a number of issues including business strategy, accountability and execution. In light of our meeting we actually switched and voted the white proxy card and voted for 3 independent directors (including Jeff Henderson) and against the rest of the board. These three were chosen because they were the newest members on the board and had come on at the time activist investors JANA were involved. We believed this was more constructive than simply voting the blue proxy. Since then, the unopposed board nomination has taken place and the nominees garnered relatively poor support from the investor base. Whist we had a constructive call with the Chairman we have again written to the company to explain our vote reasoning. We look forward to engaging proactively with the company to ensure execution, accountability and shareholder value creation going forward.

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