THE PERSIMMON LTIP PROPOSAL

An analysis for the directors of UK Shareholders' Association

Background

On 28 February Persimmon announced what they described as a 'strategy' to make dividend payments totalling £6.20 per share over 10 years beginning with calendar 2012. Against a background of a prospective EPS around 50p per share for 2012 this is in effect a commitment to manage the company for cash, distributing a high percentage of all future profits (and paying out of reserves if those prove to be inadequate) and obtaining any additional finance for expansion by gearing up the balance sheet.

On 24 September 2012 the company announced a new Long term Incentive Plan, to be approved three weeks later at a General Meeting (not the AGM). This Plan rewards senior managers solely for achieving certain levels of dividend distribution.

The proposed dividend levels in Persimmon are impressive at first glance. But this analysis shows that these will be achieved with an extremely average performance, and *could* be achieved despite dire performance. The potential rewards are also unreasonable, giving 9% of the company to current management in ten years time – a gift worth £230million even at today's share price and considerably more if management's promises are achieved.

The opening position

The company is ungeared, with 45p/share of net cash, 62p of financial assets available for sale and a land bank of 6.5 years supply valued at 464p/share. Analysts' consensus EPS for 2012 is 50p/share and for 2013 is 61p/share. The full year dividend for 2011 was 10p/share.

At June 2012 there were distributable reserves of 445p/share and the share price through October was 770p.

Selected financial data for Persimmon are shown in Appendix 1.

Incentive Plan Summary

The key terms are:

1) The Plan extends for 10 years 2012 – 2021.
2) The terminal performance condition is the payment of cumulative dividends of 620p per share over that period.
3) Dividends must be paid out of distributable reserves and the company balance sheet must remain ungeared apart from 'appropriate' financing of new assets. These conditions are called the 'underpin'.

4) The compensation awarded under the Plan comprises grants of options over a maximum of 10% of the issued share capital (30.2million shares) at an initial strike price of 620p.
5) *The strike price reduces to the extent of any dividends paid. If the terminal performance condition is achieved at the end of the Plan the strike price will be zero, all the options will vest, will be immediately exercisable and may be sold after 12 months. This also applies if the cumulative dividend target is achieved earlier.*
6) There are supplementary performance conditions relating to cumulative dividends at four intermediate 'Measurement Dates'. If an intermediate cumulative dividend target is not met a proportion of the option grant will vest (at a price and terms determined by 5. above) and the remaining options will lapse.
7) If the performance condition at a Measurement Date has been met the appropriate proportion of granted options become inalienable – they are bound to vest at some future date. The strike price continues to decline under the terms of 5) above.
8) An exception to 6) applies at the first Measurement Date (31 December 2015). If the performance condition is not met at that date no options vest and all options lapse.

Fuller details of the plan are in the Appendix 2.

The artifice

The great beauty of dividends, from the point of view of this illusory scheme, is that dividends can be paid without current performance. Only two things are needed: distributable reserves and cash (or debt capacity). Persimmon has distributable reserves of 445p/share and net cash and financial assets of 107p per share. Our analysis shows that from this strong financial base only notably incompetent performance will prevent full payout after 10 years.

To get a flavour of how easy it is, we note that if profits are completely flat for 9 years from 2013 – no growth, no inflation gain – at the analysts' consensus of 61p/share the target dividends can be paid with only 20p/share reduction in reserves and cash (in the final year). We can further see that because of the back-end loading of the scheme (shades of the West Coast Rail Franchise debacle) a notably weaker performance can be accommodated by selling assets in years 9 & 10.

Underpin

The underpin is presumably included to prevent the abuse of borrowing to pay a dividend (full text in Appendix 2). Three questions come to mind:

1) Why didn't it include a requirement to pay dividends only out of fresh reserves – thus preventing the much more blatant abuse of rewarding managers for the simple ruse of paying shareholders their own money made in prior years?

2) Why did the underpin require only an ungeared balance sheet – thus leaving unrestricted the use of 107p per share of cash and other financial assets in the balance sheet at June 2012?
3) Why didn't the underpin, while allowing borrowing for new assets, also insist on a debt reduction (or increase in cash) on the disposal of old assets?

The latter weakness, particularly, allows dividend payments to be maintained even when current profits are inadequate. This is particularly relevant for years 9/10 of the plan.

Yearsrs/9/10 – back end loading

The minimum payout for years 1-8 averages 48.7p per year. This scandalously weak threshold is below the consensus earnings forecast for 2012 - a year that was already three-quarters completed when the Plan was announced. The total over 10 years is raised to a slightly more respectable 62.1p average by the year 9/10 requirement for 115p in each year. This back-end loading is itself suspicious and its reason becomes clear when we consider the uses to which the underpin weaknesses (above) can be put.

Persimmon's land bank of 464p per share represents 6.5 years' supply. This is good management for an ongoing business but not necessary for a business managed by people with no stake in its future – which describes managers in the last two years of this 10-year plan. All that is necessary to pay a dividend of 115p if profits are still only 50p, is to sell 65p of the land bank (booked against pre-plan reserves) in year 9 and repeat for year 10.

Back-end loading also allows latecomers to the gravy train (managers who join the scheme in later years) to still receive substantial awards (see *option pricing* in Appendix 2).

The other fall back – leverage

Any business that can stand a measure of gearing, but is at the time ungeared, is sitting on an embedded asset waiting to be realised. This is the earnings that can be made by borrowing up to a prudent gearing level and spending that fund on an asset with a return greater than the cost of debt.

For a company like Persimmon, with most of its assets short term and realisable, a gearing level of 30% would be modest. Including cash and realisable financial assets there is £740million, or 245 p/share, available for spending in Persimmon for this purpose. The simple way to turn this into earnings would be to buy a low-growth (and therefore low p/e) company. If the cost of debt is, say 4% net of tax, an 8p/e company bought at an exit p/e of 10 would yield a profit boost of 6% per annum, or 15p per share annually.

The value of compensation at term

The compensation is described as an option, but because of the extreme ease with which the performance conditions can be achieved the Plan is actually akin to an unconditional grant of shares after 10 years. Even at today's share price of 770p this amounts to £233million. Taking the MD's September 2012 interim statement at face value - '……new strategy to grow into a stronger, larger business while returning £1.9billion to shareholders' one might expect a considerably higher share price and a value more like £300million. At any price it represents a gift of 9% of the company to today's managers.

The value of intermediate vesting

The structure of the Plan, with its intermediate measurement dates, ensures that substantial amounts of compensation vest to early leavers and in the event of a takeover.

The first measurement date, for example, – 31 December 2015 – requires the payment of 170p of dividends over the four years from December 2011. We note that 2012 earnings are practically in the bag at 50p/share and 107p of cash and near cash plus the backing of the land bank should be enough to cover any embarrassing slips over the following 3 years. This shamefully trivial 'target' is rewarded with the vesting of options at a maximum price of 450p over a minimum of 8.3million shares making the options worth at least £26million at the current price of 770p.

It is important (for the beneficiaries) that the target at 31 December is easily achievable since this is the only date at which failure would cause the scheme to terminate without a payout.

Inadequate Strategy

We have to question the relevance of the stated 'strategy' and, particularly, the wisdom of incentivising threshold dividend payments. A dividend distribution policy is not a business strategy; it is a financing policy. It is, or should be, a board judgement about the balance between retained profits and debt for financing the needs of the business. It says how much of the shareholders' own money is to be paid out and how much is to be retained to make a return on their behalf. It says nothing about how the business is to be run to create wealth.

The company (or its advisers) either do not understand this or hope that the company's investors won't understand the true nature of what is being proposed, as evidenced by the introduction to the Circular to the General Meeting: 'On 28 February 2012 we announced a significant change to our business strategy whereby *we proposed to create significant shareholder value by way of a Capital Return Plan…..*' (our italics).

It is ill-judged to commit to the *amounts* of such dividends up to ten years ahead. It is even more ill-judged to introduce a long term incentive plan for management focussed only on distribution of shareholders own money and not at all on what management

are supposed to be doing, which is creating new wealth. Worse, if performance is weak it actually incentivises managers to damage the company through unwise sales of assets in the last two years when the going gets tough.

Conclusion

In summary, this is not an Incentive Plan but a staged and accelerating compensation arrangement structured and presented in a way that conceals its quantum; is irrelevant to wealth creation; offers no incentive that is valuable to shareholders; and has no concern with the long term future of the company. The fact that it was approved without fuss raises important questions to be answered by a number of parties who surely should have behaved differently or should, albeit belatedly, now intervene. It also raises wider questions about the general governance process for quoted companies.

John Hunter, for the UKSA policy team, 13/11/12

Persimmon selected data — Appendix 1

Shares in issue at 24 September 2012, million	302,731

Balance sheet	@ date		
	31 Dec. 2011	30 June 2012	pence per share
Intangible assets	250.8	248.6	82.1p
Available for sale financial assets	164.0	186.9	61.7p
Other non-current assets	59.6	63.1	20.8p
Inventories	2,003.4	1,965.8	649.4p
Cash	41.0	136.9	45.2p
Other current assets	54.8	66.8	22.1p
Loans & borrowings	(0.1)	(1.7)	(0.6p)
Other current and non-current liabilities	(734.2)	(772.5)	(255.2p)
Net Assets	1,839.3	1,893.9	625.6p
Note: inventories include freehold land	*1,486.0*	*1,404.0*	*463.8p*
Distributable reserves	1,294.0	1,348.5	445.4p
Other reserves	545.3	545.4	180.2p
Total equity	1,839.3	1,893.9	625.6p

Earnings per share	---------------------Actual------------------------				----Consensus forecast----		
	2011 H1	2011 H2	2011 year	2012 H1	2012 H2	2012 year	2013 Year
	15.5p	20.6p	**36.1p**	25.4p	25.4p	**50.8p**	**61.1p**

Long Term Incentive Plan: Terms **Appendix 2**

The Plan grants options over a maximum of 30.2million shares (10% of issue) subject to payment of a minimum level of dividends over the 10 years 1/1/2012 – 31/12/2021 (the 'Capital Return Plan'). The options vest in tranches on 5 'Measurement Dates' provided the cumulative minimum dividend payments to those dates have been made.

We first state the performance condition as stated in the Meeting circular. We then repeat with additional calculations not included.

Performance Condition as tabled in company's circular

Cumulative Dividends paid during the period	Measurement Dates
£1.70 per share or more	By 31 December 2015
£2.80 per share or more	By 31 December 2017
£3.90 per share or more	By 31 December 2019
£5.05 per share or more	By 31 December 2020
£6.20 per share or more	By 31 December 2021

Performance Condition with additional analysis

Measurement Date	Years since prior date	Cum. dividends, p/share	Dividends since previous date	Dividends per year, cum.	Dividends per year in period	Proportion bound to vest in future
31 Dec 2015	4	170	170	42.5	42.5	27%
31 Dec 2017	2	280	110	46.7	55.0	45%
31 Dec 2019	2	390	110	48.7	55.0	63%
31 Dec 2020	1	505	115	56.1	115.0	81%
31 Dec 2021	1	620	115	62.0	115.0	100%

Note: 'Dividends' and 'Proportion bound to vest' are shown assuming the minimum terms of the performance condition are achieved. The actual vesting proportion is computed on the actual cumulative dividends divided by 620, and the performance condition is stated in terms of cumulative dividends only – there is no minimum per period.

Underpin

Options only vest if dividends are 'financed out of retained earnings' and ' the company has an ungeared balance sheet at the relevant Measurement date except to take account of events and/or circumstances which the Committee fairly and reasonably determines are appropriate, for example (but not limited to), any financing provided in relation to a corporate or land acquisition by the Company or a member of its group or required for normal working capital within the Company's banking credit facilities'.

Translation: the company must remain ungeared except to the extent that it spends money on anything the committee deems sensible. There is no prohibition on selling assets to remain ungeared.

Option pricing

Options are priced at 620p for the initial grant, the higher of 620p or market for subsequent grants but *reduced by any dividends paid in the performance period following grant* (but not below zero). For later grants the strike price is the higher of £6.20 or share price *but again reduced by any dividends paid in the performance period following grant* (but not below zero). Therefore if the LTIP runs to term the option price will be zero for recipients of the initial grant and may be zero for subsequent recipients – i.e. there will be a share issue to management of up to 10% of the issued capital of the company.

Exercise

Options may be exercised immediately on vesting, apart from some minor exceptions, and the shares may be sold after a year.