

PROTECT – POLICY AND MANAGEMENT

ShEx Board 5 May 2011 (11)10

Portfolio Unit Development

Purpose: To seek agreement from the Board to changes to the way we monitor and control our portfolio companies.

1. Introduction

Anthony Odgers was recruited in October 2010 in the new role as Head of Portfolio, with an objective to improve and move forward the performance regime for the ShEx portfolio of companies.

This paper proposes a realignment of the Portfolio Unit, providing more intensive focus on a smaller range of the bigger companies, and where resources allow, smaller companies where we have had a major historic involvement. For the remainder, we would provide financial monitoring - and ad-hoc support on an “as needed” basis.

2. Initial observations

i) ShEx does not have the level of resources necessary to give all our companies the ideal level of attention

ShEx is not realistically going to be able to take on significant additional resources in the short term; we may struggle to replace the senior non civil-servant capabilities we currently have, at the same time as the need for transaction expertise is increasing significantly.

Conclusion: We need to focus our resources where we can have the highest impact, while remaining available to all portfolio companies to address emergencies or transactions. We may need to recruit some additional senior private sector resource if we are to go on to a number of large company boards.

ii) We do not have a detailed enough tracking of the performance metrics of all our portfolio companies

ShEx tracks general financial performance and performance against budget and business plan, has performance and dividend targets for individual assets and performs valuations on a rolling 2 year basis. While focused on the big policy issues, we do not have the fullest range of detailed private equity ownership disciplines. Standards across the portfolio vary and not all of the company teams have a detailed understanding of key performance indicators and drivers for revenue and cost or credible benchmarking. This limits our ability to set challenging but realistic targets for the management teams. We also do not track well measures of how well or cost - effectively the companies are delivering their policy objectives. Finally, not all companies have a 5 year business plan with key drivers identified.

Conclusion: ShEx need to collect more, more timely and better information from our portfolio companies. In particular, we need to measure achievement of policy objectives explicitly. This will tie in to helping policyholders define better what they are purchasing.

PROTECT – POLICY AND MANAGEMENT

ShEx Board 5 May 2011 (11)10

iii) Focus on the companies alone is not enough

Unlike companies in a private equity portfolio, our portfolio companies are affected by an environment where:

- Government departments are often poor customers, buying services with relatively junior people insufficiently clear as to what they are buying and with short term objectives in mind;
- many of our portfolio companies are small in terms of the owning department's budgets, sponsoring policy staff change frequently and in any event are not well trained to deal with commercial matters; and
- Treasury is not prepared to commit irrevocably multi year cash to fund companies or purchases by departments from companies.

The companies themselves are incentivised to be defensive of resources and build up fat so that they can survive when spending restraint hits, with no inbuilt counterbalancing incentive towards profitable operation. Companies themselves are also, in general, poor at thinking of their policyholders as customers and pro-actively developing interesting and well costed products that meet policy objectives.

As such a large amount of ShEx portfolio time is spent focused on how companies interact with their government customers – and this is critical to the position of our companies. For example, more time is spent on the data companies addressing the threats and opportunities in free data than in any independent benchmarking of company performance. The failure of the FSS was to a large part due to a policy vacuum and the failure of the procurement regime, which ShEx identified but, despite repeated attempts, was unable to change. There is a further example in the Post Office case study later.

Conclusion: We spend a large amount of time working with the various government stakeholders rather than just spending time with our portfolio companies and it is essential that we keep doing so. However, we do need to help our companies and their customer departments set up more effective commercial relationships with each other and thus reduce our role as middleman.

iv) ShEx doesn't always have the position it needs to monitor and challenge effectively

A Board seat, or at least an ability to attend Board meetings, is likely to be important to understand the business in detail, to be able to point out the government related issues to the Board as a whole, and to have the most credibility with executive management. We do not sit on the Board of some of our biggest portfolio companies (e.g Royal Mail, Post Office, NDA).

Conclusion: We should look closely again at our **Core** portfolio companies (see later) and aim to take Board seats unless there are good reasons not to. We will need clear terms of reference so that companies and departments know our role as owner – not customer. A seat on the remuneration committee in particular will help drive the link between ownership, objectives and management. (While we can help guide portfolio companies as to how best to interact with policyholders / government customers, we will not hold that role within ShEx.)

PROTECT – POLICY AND MANAGEMENT

ShEx Board 5 May 2011 (11)10

v) The environment for successful management for Government owned businesses is deteriorating but the environment for privatisation is improving

Reduction in government spending makes HMG a less attractive customer and most of our businesses will need to look to the private sector for growth and / or restructure to meet lower revenues. All of this requires strong management and private sector capability at a time when there is renewed focus on reducing management pay and incentives and reducing the use of specialist consultants who would otherwise take some of the strain.

At the same time there is a greater willingness from the centre to push for private sector investment / outright privatisation as seen in the creation of the PEX (A) sub-committee.

Conclusion: we should take every opportunity to explore ways to promote private sector involvement where it makes sense.

3. Proposed changes to our approach to portfolio companies***Core and Light Touch involvement***

We would propose two levels of involvement with assets: Core and Light Touch.

Core involvement for ShEx would usually include a seat on the board; providing direct advice to Ministers; acting as the primary company (as opposed to policy) driver within Government; and having the ability to incentivize management – i.e. having the key input on management targets and any linked remuneration.

Light Touch involvement for ShEx would usually consist of quarterly meetings with companies; a board dinner; steering the strategic dialogue (as opposed to formally driving performance); involvement in significant investment decisions; spotting storm clouds and being more involved in a crisis; and involvement in transactions and management change.

This does not mean that ShEx will materially reduce its level of monitoring on Light involvement companies or its level of commitment when they need us for a transaction or in a crisis. It does mean that we would step away from some of the day to day hand holding for companies and their owning departments for the smaller portfolio companies, and also the commitment of resource to new small companies that might otherwise come into the portfolio (e.g. from MoD or DH).

Core should cover the assets where we are able to have the biggest impact, e.g. with enterprise value of more than £1bn and ShEx having the ability to exercise all or most levers, together with (resources permitting) those assets where we have historically been heavily involved. To the extent that we do not have the necessary resources, we should look to transfer those smaller assets where we have historically spent a lot of time but where the value we can now add is limited (e.g. possibly Royal Mint) to the Light Touch category.

PROTECT – POLICY AND MANAGEMENT
ShEx Board 5 May 2011 (11)10

Provisional Split of ShEx Portfolio

On the basis of the above criteria, a split of the portfolio would look something like the following.

Core	Light Touch	Exit (already actioned)
NDA PDC Royal Mail Post Office Student Loans Urenco CDC? Green Investment Bank? Smaller core (resource permitting): Eurostar Land Registry* Met Office* Ordnance Survey* Royal Mint	BNFL (but Board seat) Channel 4 ECGD FSS NATS (if residual stake) NNL Scottish Water Working Links (Keep Board seat for R&D) UKHO	Actis BWB NI Water PUK UKAEA Tote

* May be part of PDC

There is significant activity within the Core portfolio. We are driving the creation of PDC and will ensure that the correct governance is set up from the start. As POL separates from the Royal Mail, we will take a more significant direct role in the governance of POL. We have no direct governance position in relation to the Student Loans Company at present, but if clearance is given for the sale process, we anticipate that we will need to become significantly more involved in its governance (or at least that part of it that is charged with collecting the loans). DFID is in the process of redefining the mission and governance of CDC, and we are discussing with DFID the role ShEx would play. Finally, we are involved in the set up of the Green Investment Bank and will look to have the right ShEx involvement from its start.

We would expect the portfolio and the allocation between Core and Light Touch to evolve over time dependent on ShEx resources, company / departmental needs and the identification of other government companies where we may be able to add material value. Entities such as Network Rail, the Big Society Bank, the MoD procurement company, the Environment Agency, and possibly certain health assets might at some future date be worth considering for inclusion in the portfolio.

PROTECT – POLICY AND MANAGEMENT

ShEx Board 5 May 2011 (11)10

ShEx Investment Reviews

ShEx currently performs an annual, and an interim, investment review for assets in the portfolio. Following the split of assets into Core and Light Touch involvement categories, investment reviews would differ for each category (see appendices 1 and 2). For Core assets, we would expect detailed annual investment reviews with higher visibility of policy delivery, key business drivers, an updated annual valuation, a better definition of the risks and opportunities for the company, and key targets for the year. There would be a update quarterly. Light Touch asset reviews would involve less detail and we would retain our bi-annual valuation regime. The focus would be on performance against target and any emerging risks and opportunities that would likely require more significant ShEx involvement. We would continue to use the Traffic Light checks but the expectations may well be different for Core and Light Touch assets.

4. Case study - Post Office Limited (POL)

Background

POL is a subsidiary of Royal Mail Postal Services (RMPS). It is heavily subsidised by HMG, but the overall policy objectives are unclear other than a requirement to maintain a national network of over 11,500 branches and to avoid a post office closure programme. POL does provide services to a number of government departments but often finds itself undercut by competitors who are able to look at the government services on a marginal cost basis. There is a significant change programme to be undertaken - bringing down the costs of the large Crown post offices, and changing the relationship with the franchised post offices move more from fixed to commission based pay. HMG has committed that POL will remain in Government ownership and may be mutualised.

ShEx has no Board seat (on either POL or RMPS), and the management information provided to ShEx doesn't always provide us (or, we suspect the company) with the early warning mechanisms to understand where financial problems are developing.

Illustration of new approach

As POL disengages from RMPS, we would look to take a more active role, and have already agreed with ministers and RMPS to take a Board seat once the business separates from Royal Mail. We have also agreed with the Chair of RMPS that we will jointly select a new Chair for POL.

As part of our increased focus, we will look to help the company and policy holder within BIS define what the policy objectives are with greater clarity and we are developing a proposal to OGDs for an umbrella agreement with UK government departments that seeks to avoid the situation where individual government departments are incentivised to reduce their individual costs – only for a larger cost to be borne by the rest of Government to support the network.

We will also work to improve the quality of management information on, for example, contracts coming up for renewal, on cost benchmarking and on a set of metrics to understand if the change programme is going to plan. We have agreed with

PROTECT – POLICY AND MANAGEMENT

ShEx Board 5 May 2011 (11)10

the current finance director of POL to review the information the Board gets to allow us a better “dashboard” of indicators, and will use the arrival of a new finance director within the next 3 months to make sure we (and the Board) have the right level of information.

PROTECT – POLICY AND MANAGEMENT
ShEx Board 5 May 2011 (11)10

Appendix 1

Annual and Quarterly reviews for Core assets

Annual Review for Core assets would cover:

- Government policy objective (assuming there is one) and how measured / monitored
- Agreed ShEx role with owning Department
- Company key activities (brief description) and its non financial metrics and targets
- Company business plan (3 yr historic, 5 year forecast), detailed template to be provided
- Performance against targets – financial / dividend and customer delivery (to include specifically milestones on major capital expenditure programmes or restructuring)
- Board and management – right Board and Management? - performance targets and achievement
- Opportunities– possibly benchmarking to show efficiency potential, new products – and strategy to capitalise
- Threats / risks – and strategy to mitigate
- Valuation – together with movement from last time and explanation.
- Level of ShEx resources required
- Review of whether the company should remain public sector
- Traffic light checks as summary
- Appendix showing Chair letter / ShEx terms of reference owner department.

In addition:

- Head of Portfolio to meet Chair
- Head of Portfolio to meet owner / policyholder and HMT

Quarterly Review would cover:

- Performance against budget
- Status and performance improvement actions
- “Traffic light” checks

PROTECT – POLICY AND MANAGEMENT
ShEx Board 5 May 2011 (11)10

Appendix 2

Annual and Interim reviews for Light Touch assets

Annual Review for Light Touch assets would cover:

- Much more detailed numbers including a measure of policy objectives delivered
- Agreed ShEx role with Department
- Strategic issues/potential problems
- Review of likely ShEx involvement over year
- Valuation every 2nd year
- Dividend returns to Government
- Whether HMG remained the best owner of the asset
- “Traffic light” checks

Interim Review would cover:

- Performance against budget
- Update on key issues/ShEx involvement
- “Traffic light” checks

PROTECT – POLICY AND MANAGEMENT
ShEx Board 5 May 2011 (11)10

Appendix 3

Current Position on Board Seats (as of Feb 2011)

Core

CDC ?	No Board Seat
GIB ?	N/A
NDA	No Board Seat
PDC	N/A
Post Office	No Board Seat
Royal Mail	No Board Seat
Student Loans	N/A
Urenco	Board Seat

Light Touch

Actis	No Board Seat
BNFL	No Board Seat
Channel 4	No Board Seat
ECGD	No Board Seat
Eurostar	Board Seat
FSS	No Board Seat (resigned)
Land Registry*	Observer Status
Met Office*	Board Seat
NATS	No Board Seat
NNL	No Board Seat
Ordnance Survey*	[Observer Status/Board Seat]
PUK	No Board Seat (though previously had one)
Royal Mint	Board Seat
Scottish Water	No Board Seat
UKHO	No Board Seat
Working Links	Board Seat

*Heavy if in PDC