Candor

Case Study 1: Burberry

Prof Osterrieder and Michael Seigne co-authored a white paper, which can be found on Candor's website, along with a "one pager" summary. We think you might find it helpful to familiarise yourself with our arguments in that paper before diving into the case studies. The paper is a bit technical/boring (sorry), but it provided the foundation for these examples.

We are saying that there are problems with certain execution products, ones whose broker fee/profit is derived from beating a "Bogus Benchmark". The problem does not always manifest itself in terribly high fees, or in terrible risky outcomes, but that is not because the products are ok, but because the stock's price path didn't give an opportunity for the "problem" to display itself.

A second point is one on transparency. Each contract between a broker and a company is private, we never get to see the parameters that have been agreed within these contracts. There are good reasons documents need to stay private, however it is the details within these documents that allow for the issues to persist. We understand that there are several possible variations of these contracts which will depend on factors such as who the broker is, what specific structure is agreed, how informed the company and their advisors are and so on. The main parameters that we don't get to see are, of course, the ones that determine any fees. Also, ones that govern factors such as: if there is a date before which the broker cannot complete the program; if there is a minimum value that the broker must trade each day? If not, what happens to the benchmark calculation if the broker does not trade on a given day? Does this differ if the reasons for not trading are due to regulatory limits, or the brokers choice? Etc etc…

The broker will be trying to gain as much flexibility as they can…the longest trading window, the highest splits and lowest levels of guarantee etc (see Appendix 4). The broker/company contracts for these products are also written so that the broker gets full discretion on the trading decisions, within these set parameters. This is in part to allow the share buy-back to be executed during a company's "quiet period".

The design of these VWAP products is to beat the "Bogus Benchmark", and the brokers are directly incentivised to achieve this by being paid a portion of this outperformance as their only fee. The outperformance is created by trading more/less value when the stock price moves away from the Benchmark. This is why the stock's price volatility over the trading period can affect the outperformance and hence the fees dramatically.

We reiterate the point that our criticism of these products is that their overall design is not in the interest of shareholders. These products break every rule that we use in equity execution for the rest of the trading community. Their design also incentivises poor risk management that is a "hidden" cost to the shareholder. This is due to the fee

structure using a bad performance benchmark. We will try to point out these issues as we progress through these examples.

The risk we are specifically talking about is the risk of buying less shares for the value of the buy-back due to the future share price moving higher during the execution period. This risk is directly related to the time taken to execute the program.

The first example is Burberry.

We picked this firm, through no fault of their own. In part their name is close to the start of the alphabet, in part because we could get the web scraper to work to collect most of the relevant trading data and in part because we believe that the corporate finance professional responsible for the implementation of their share buy-backs is extremely experienced. We would also point out that the levels of transparency in their financial on topics like the implementation costs of their buy-backs is very good, which we applaud. We would also like to point out that we have not asked their permission, given that all the data we are using is public. We are not singling them out for any mistake on their behalf, we could have picked any number of other firms as we suggested above. Lastly, we know, not only by inferring from the press release language, and the trading patterns, but also because they were transparent and confirmed to us that they use these products. In our opinion Burberry are the "good guys", even though we are using them as an example.

It is also worth noting that in these Burberry examples the stock price did not fall sharply at any point during the execution of these buy-backs, so the fees that they paid are nothing like as high as some others we have mentioned elsewhere.

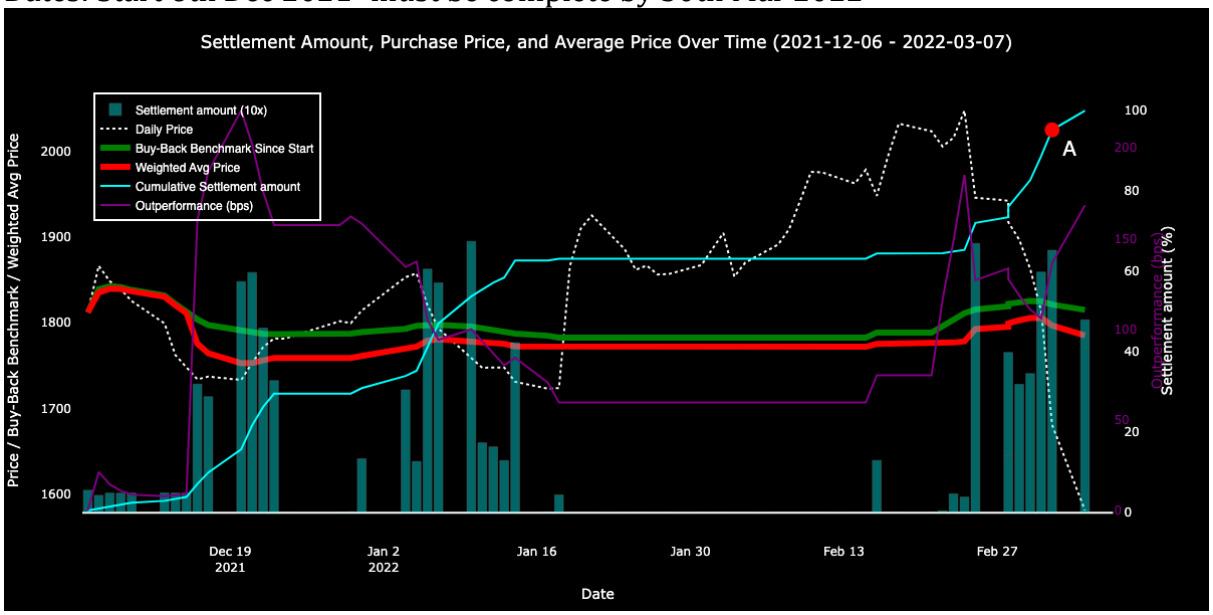
Burberry have completed 3 buy-backs since FY 20/21 and currently have a live program this fiscal year.

Program 1: On 3rd Dec 2021 Burberry announced a £150m share buy-back program
Program 2: On 18th May 2022 Burberry announced a £400mil buy-back program that would be split into two £200m tranches. On the 30th June they announced the start of the1st Tranche
Program 3: On 4th Nov 2022 they announced the 2nd Tranche.

At the time of writing they had a live Program: On the 18th May 2023 they announced another £400m program, again split into two equal tranches with the first one still in execution now.

Note in all cases the Company states that the purpose of the program is "to reduce the share capital of Burberry". This means that the execution goal should be to buy as many shares as possible.

PROGRAM 1
Value: £150m Broker: JP Morgan Fee paid: ~ £2.3mil (1.5%)
Dates: Start 6th Dec 2021- must be complete by 30th Mar 2022



These charts are for illustrative purposes only, the data is not exact and the dates along the bottom are not very clearly lined up with the trading days above. We also had issues with our web scrapping tool as it sometimes mis-matches the report date and trade day so please forgive these minor glitches, they make no difference to the arguments we are trying to make. The weekends and market holidays are also shown, so some of the days where there is no turquoise bar are weekends and holidays, i.e. the 6th and 7th day in this chart are weekends, as are the Christmas/NY holidays or they are when the broker did not trade for either a regulatory reasons ("rule 1.05") or they choose not to trade.

For the first 8 trading days the broker spent roughly the same value every day (£0.7mil represented by the turquoise bars). You can see that the weighted average price (red line) of the shares bought so far was roughly the same value as the VWAP benchmark (green line) and therefore the "outperformance" (purple line) is virtually zero at this point.

On the 9th day the broker changes the trading pattern from £0.7m a day and spends £4.8m. The share price (white dotted line) on this day is below the benchmark (green line) and so the outperformance (purple line) jumps right up. From this point on until mid-Jan, you can see that if the daily share price (white dotted line) is below the benchmark (green line) the broker spends relatively more, and if the share price is above the benchmark they spend relatively less.

On the week of the 18th of Jan, the share price is just below the benchmark, the program is 60% complete by value, the broker still has another 2 and half months until the end of Mar, the latest completion date.

On Jan the 19th the company announces results, which seems to have been taken well by the market as the share price jumps well above the benchmark. The broker stops

trading altogether and doesn't really trade again until the end of Feb. At the end of Feb, the share price is significantly higher and as the share price starts to fall quickly the broker completes the buy-back on March the 7th, 3 weeks before the latest completion date.

Where are the issues?

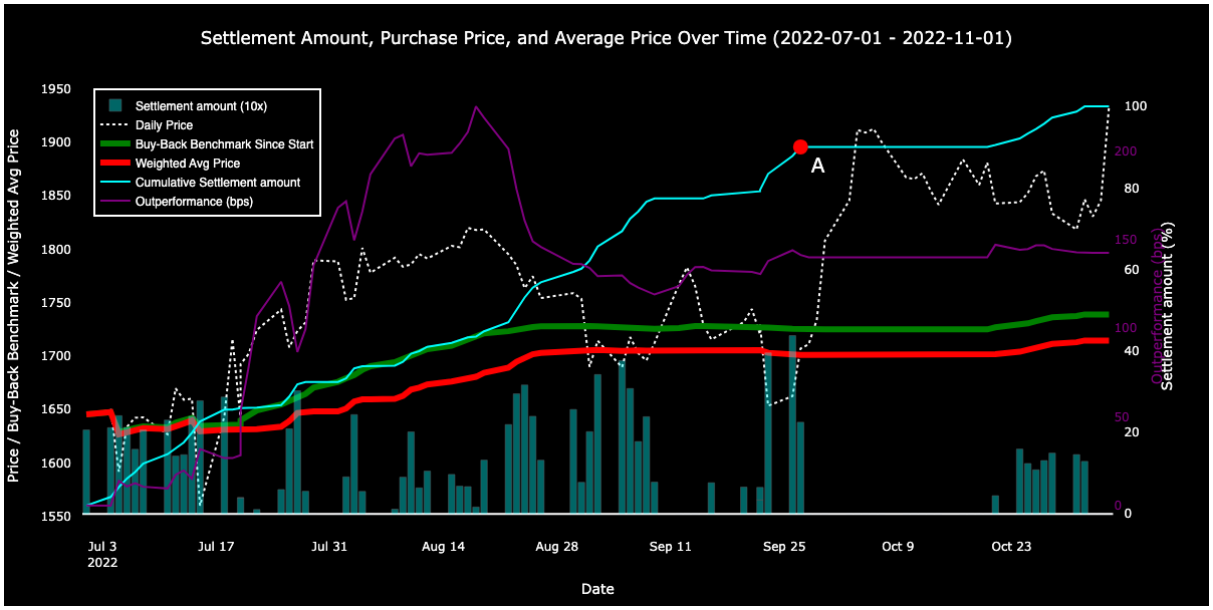
Price Risk: As we have tried to explain in our paper, at the start of the program the "value at risk" is the highest. The broker spends approx. £6mil at a price of £18.11 in the first 8 days (share price on LHS of chart is quoted in pence for UK shares). They spent approx. £45m at an average price of £18.41 in the 8 trading days between the 24th of Feb and the 4th of Mar. Remember that the goal of the buy-back is to buy as many shares as possible. From a shareholder perspective we think that the question should be "if you were happy to spend £45mil to buy 2.46mil shares at £18.39 in Feb/Mar why were you not happy to spend that money closer to the start of the program in Dec when the stock price was £18.11 and buy more shares? In effect, this delayed spending has not only realised a "loss", but if could have been much worse if the stock price had stayed up at £20 or gone higher in March, then we would have bought even less shares.
We will try to show more examples of this "hidden" cost to shareholders.

Fee Structure:

In mid Jan the average price of the shares they had bought so far was approx. £17.72. When they completed the program, the average price for all the stock they had bought was slightly higher at about £17.85, so this means slightly less shares bought back than if they had managed to complete the buy-back at the mid-Jan price. Now let's look at the effect it had on the broker, who is paid out of the "outperformance" bucket. This went from about 60bps (purple on RHS) to finish at about 170bps. The value of the outperformance went up about 180%, while the Company paid a worse price for their shares (or bought less shares than they could have done). This is what we mean when we say that the broker and the shareholders incentives are not aligned. For this to be fair, the broker should only get the opportunity to get paid more if client has brought more shares, not less.

PROGRAM 2

Value: £200m Broker: Morgan Stanley Fee- across Program 2&3 £3mil
Dates: Start 1st July, must be completed by 4th Nov 2022

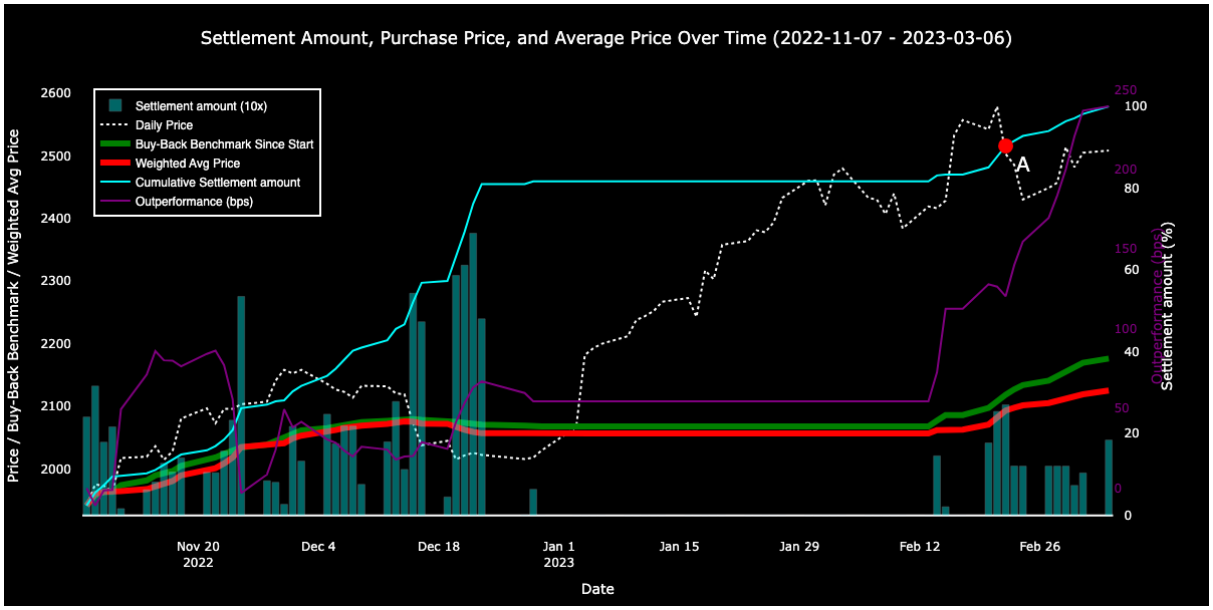


What is hard to see in this chart is that there are 9 trading days when the broker bought less than 500 shares on each day, in fact there are 4 days in a row when they only traded 4,6,2 and 4 shares. These quantities are too small to show up as turquoise bars in the chart. All these small trades occur on days when the share price is above the benchmark. What is the value of this? Every day that there is a trade, that day's VWAP counts in the benchmark. If the share price is above the benchmark on that day, then benchmark price rises. However, buying only 4 shares (spending £69) does not materially affect the overall average purchase price (no. of shares) of the buy-back, so the effect of this process is to move the benchmark higher, while not moving the average purchase price higher. This makes it easier to outperform as the benchmark is now a higher price. This "feature" explains why brokers tend to run programs to as close to their latest completion date when the share price is above the benchmark.

Risk: This is another example of cost to the company. Look at the height of the turquoise bars at that start, and in the middle of the program. The broker is buying more value later and at higher prices than at the start.

Fee: The outperformance bucket finished at about 140bps. Another example of the average purchase price raising while the value in the fee bucket also rises. The point marked A on all these charts is the point where 90% of the value of the program has been spent. We find it interesting to different programs by looking at the situation at point A. For example, compare the number of trading days after point A in different scenarios. There are always more days after A if the share price stays strong and is above the average at point A, normally the number of days equals the number of allowable trading days left in the contract in this scenario.

PROGRAM 3
Value: £200m Broker: JP Morgan Fee- across Program 2&3 £3mil
Dates: Start 7 Nov '22, must be completed by 6th March '23



Risk: the same issue appears as in Programs 1&2. The cumulative value of trading in weeks 1 and 2 (~£30m) is less than the £47m on the 4 days before Christmas. Now look at the £36mil traded from mid Feb to the end of the program. The price difference between those shares bought at the end is 25% higher than those bought in the first 2 weeks. So that money bought 25% less shares back. This is the "hidden" cost of poorly managed risk caused by this product design. This £9mil differential due to price would have bought approximately 450k more shares, or approximately 5% more shares cancelled. Now we don't know what the "earliest completion" date is in the program's contracts, so we are not saying that the broker could have completed before Christmas. Our point is the structure of these products are terrible for the shareholders risk, as they should have been able to if the MAR (Market Abuse Rules) allowed for it.

Fee: The outperformance on this program was about 240bps. The outperformance more than doubles from the end of Dec to the end of the program (from 70bps to 240bps).

The stated goal of Burberry's buy-backs is to "reduce the share capital of Burberry". We hope it is becoming clearer that these products are not designed to do this well. Burberry paid £6mil in fees for these products. By contrast a simple agency fee would have been in the 5 to 8bps range (less than £0.5mil).

Going back to the topic of risk. Many people will think that surely the risk of the stock price going down is equal to that of the stock price going up, so only looking at the issue as a "cost" when the share price is higher is unfair to the broker. This is a good point. We would argue however that job of the broker is to manage down that risk. The design of these products does not incentivise this at all. In fact, the design of these products, actually at times incentivises the broker to extend the shareholders risk, as the broker can get rewarded through generating a higher outperformance regardless of the direction the stock price moves, it just has to move. Shareholders on the other hand get the short end of the stick as they must pay the broker a portion of the out-performance regardless of whether the price move enable more or less shares to be purchased.