BREXIT SPECIAL REPORT

IPREO
CORPORATE SPECIAL REPORT

Words and Actions from the Buy Side

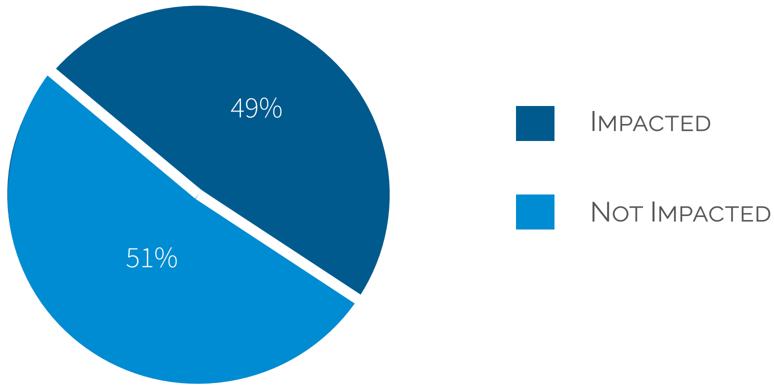
The Brexit vote to "Leave" on June 23, 2016 ushered in a heightened level of concern and uncertainty that was felt in markets around the world.

Speculation by economists, politicians and pundits on Brexit's impact will continue for the foreseeable future, as Great Britain's ultimate exit from the EU will take months, if not years. Ipreo will look to the words and actions of the most important actors in the equity markets, buy-side investment managers, to assess how Brexit is impacting the investment process and how best to allay anxiety caused by uncertainty through effective investor relations.

THE BUY SIDE TALKS

When news of the Brexit vote broke, investors located within Europe were heavily tapped by different media sources to decipher how this event impacted their market views and investment approaches. However, North America is the deepest pool of equity assets in the world, and the opinions of this critical group of investors regarding Brexit was overshadowed by those of European market participants. In late July and early August (prior to the Bank of England announcing its extension of QE), Ipreo's Perception Analytics team interviewed nearly 45 major buy-side investment firms located mostly in the United States and to a lesser extent Canada in order to uncover how this influential population was digesting the Brexit news.

Has Brexit Impacted Investors' Decision-making Processes?



Uncertainty around the implications of Brexit is illustrated in the split feedback we received regarding the Leave vote's impact, if any, on the investment process. The responses from the buy side on Brexit, however, aren't as specific and detailed as we normally receive from a group that is so well-informed. The uniqueness and first-time status of Brexit are likely behind the somewhat generic reasons behind the buy side's concerns and the cautious and defensive portfolio adjustments that have been made. For now, this group of investors is not going to let the unknown dictate their buy and sell decisions.

Respondents who say that Brexit has influenced their investment decision-making processes highlight that:

- It increases both the risks of other countries leaving the EU and of global economic conditions slowing
- They invest in companies with UK and European exposure and are worried about what the uncertainty in those markets will bring
- They are revising earnings estimates and price targets on a case-by-case basis based on company exposure
- They now seek more defensive positions
- They are taking advantage of the entry opportunities that this event presents from a valuation perspective

Other respondents state that Brexit has not changed their investment decision-making process because:

- It is still too early to understand the long-term implications of the vote and to plan accordingly
- They expect the markets to overreact and be excessively volatile in the near term but do not think it will have substantial long-term impacts on the economies of the EU
- Their investment process already accounts for the possibility of such events and their portfolios are hedged for these types of external risks
- They do not operate at a level of sensitivity that would directly cause them to increase or decrease their positions

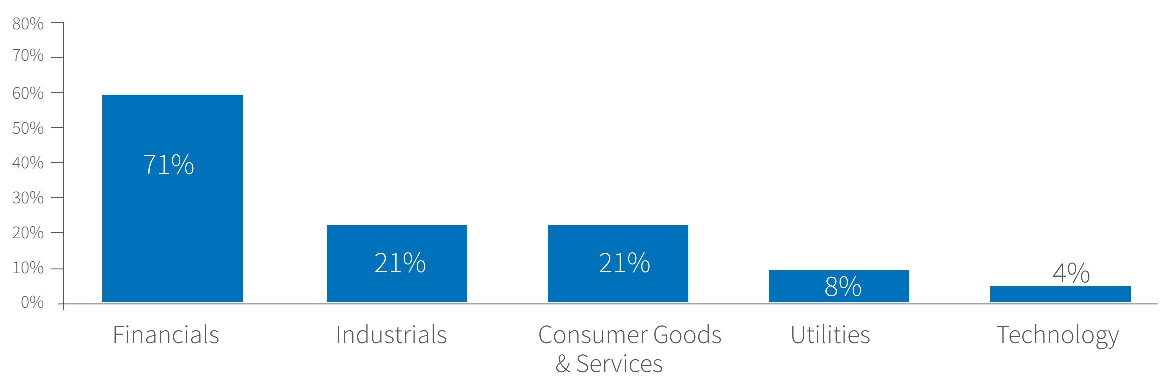
> "We assume that things are going to be overly risky and we will need to get more defensive. Our investment process is much more focused on fundamentals, and now fundamentals have taken a backseat. It is more about positioning and being in more defensive US-centric areas."

> "The vote creates a lot of uncertainty in the minds of businesses, especially the ones exposed to the European markets. If you are facing an uncertain environment, you tend to hold back on whatever investments you are making. For me, the first thing I did was look at the companies with European exposure in my portfolio and, for better or worse, I decided to pare back those positions."

> "We do not know, nor does anyone else know, what the long-term implications will be stemming from the vote. There are a lot of contracts and other things that will have to be worked out, but we are here to identify the best businesses, not play the macro stuff. We will not avoid regions or rebalance our portfolio around an event where there is so much still unknown."

> "Our process already captures the possibility of events like Brexit. We expected a period of volatility around that event and planned for that. We have to take into account the expected changes in earnings and revenue associated with the changes in currencies. Brexit has changed our outlook of currencies and growth in various regions but has not changed the way that we evaluate those things."

Which Sectors will be Most Impacted by Brexit?



One area that has been consistent is the sentiment that financial companies (particularly banks) and companies tied directly to economic activity (i.e. industrials and consumer stocks) will be the most negatively impacted. North American investors agree and the feedback does not portend well for future investment going into financials, in particular, until the impact of Brexit is clearer.

Most respondents expect the Financial sector to be most impacted by Brexit because:

- Short term, banks are directly impacted by the decrease in interest rates and currency volatility (as European currencies fall and the US dollar becomes more powerful)
- Longer term, the UK is currently a financial hub for European banking and there is uncertainty about how this sector's cross-border relationships will be affected
- Funding from the UK and Europe across global markets will be reduced

Some respondents expect the Industrials sector to be among those most impacted by Brexit because:

- Companies are less inclined to pursue large expenditures on assets like capital equipment when they are uncertain about the future of the economy
- The questionable outlook for international trade could impact manufacturing and production industries

Many respondents believe that the Consumer Goods & Services sector will be most impacted because:

- Discretionary spending (e.g. travel services, retail) will be impacted by weakness of the pound and euro
- GDP growth is expected to be slightly lower than forecasted for the near term, which will lower consumer spending

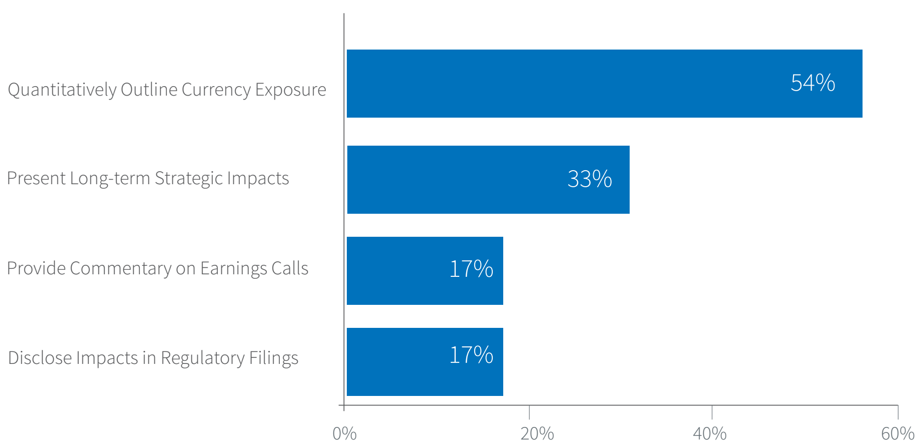
> "Banking will likely be the sector that is significantly impacted because of the financial institutions based out of Europe. A lot of banking is done for Europe out of the UK, so what does this mean for them? Are they going to have an agreement where they can cross-collaborate?"

> "Brexit caused interest rates to go down and anything that is interest rate sensitive is getting a bid. Additionally, risk has gone up and anything that is a yield proxy, whether it is utilities or staples, has gotten a bid. It has been sort of a big risk tradeoff."

> "The most impacted sectors will be staples and retailers with European/UK exposure. Based on that, we are just looking at 100% US-centric businesses with no effects-risk and particularly names that do not have any UK exposure as we are anticipating a recession for the UK and/or Europe over time."

WHAT THE BUY SIDE WANTS TO HEAR FROM IR

The dominant overarching theme of Brexit is uncertainty: uncertainty of the timing, economic impact, and ability of the EU to survive as an economic bloc in the long term. These questions will be answered over time and are mostly out of the control of individual companies. In times of uncertainty, investors value information that will let them assess the potential impact. Of course, companies may be as uncertain as the investment community is in terms of the eventual outcome and long-term impact of Brexit. Nevertheless, quantifying your current revenue and expenses exposure to currency fluctuations and providing a narrative, even if it is still developing, on how strategy will react to Brexit will be welcomed by the buy side.



- Most respondents prefer IR teams to be proactive by reaching out to investors and providing a statement regarding the business implications of Brexit, regardless of whether or not a company actually faces exposure. During times of heightened uncertainty, respondents agree that a statement from IR can provide reassurance to the investment community.

- When asked how a company should approach these discussions, several respondents recommend that IR should delve into the financial impacts of Brexit and quantitatively outline the company's exposures to the pound and euro. Specifically, these respondents ask that IR articulate the potential risks to earnings, revenue, and capital structure in order to avoid negative surprises.

- Many respondents suggest that IR should outline the long-term strategic impacts regarding the potential upside and down-side scenarios caused by Brexit. While it may be difficult for companies to provide detailed insight, management and IR should be able to determine how much of the business is dependent on the UK and communicate whether or not that will alter the future strategic direction.

- A small portion of the population believes that IR does not need to reach out to investors regarding Brexit simply because it is too early to understand the details, and the information provided would not be any more insightful than investors' own presumptions. A few of these investors suggest that IR should reach out only if Brexit poses major repercussions for the company, but they do not recommend this across the board.

> "Clearly, IR should communicate what they expect the impact of Brexit to be. It is okay to say that they do not have a strong view because there is increased uncertainty, but IR needs to say something. IR should be incorporating that into quarterly discussions and earnings calls, and I expect U.S. companies to add language in their 10-Qs about it."

> "It is helpful to know what the revenue exposure is to the UK and to EU countries. Additionally, something that is rarely disclosed with transparency is what the currency exposures are. Aside from revenues denominated in sterling, how about expenses denominated in sterling? The same goes for Euro-based revenues and Euro-based expenses. What does it mean for revenues, expenses, and the bottom line when we have currencies moving how they have been post-Brexit?"

> "There is a lot of uncertainty about what Brexit means for the end markets. Companies should work through a scenario analysis (bear/base/bull case) and communicate it to investors – this will give them a frame of reference as to how to view the company. I tend to believe Brexit will be more positive than the market feared."

> "I do not expect anything from IR because they do not have answers. I think they should just admit that they do not have answers. I do not know how IR would know their companies' exposure to Brexit. The UK is part of the EU right now, so they have not even negotiated the terms under which the separation will occur. What would IR explain?"

THE BUY SIDE WALKS

Understanding buy-side sentiment is certainly an important component to formulating a communications and outreach strategy to address the issues that Brexit has raised. It is equally (if not more) important to keep a close eye on the portfolio adjustments the buy side is making to understand the risk in your shareholder base and the challenges and opportunities to attract new capital to your story. A fundamental part of investor relations is strategic outreach to potential investors in order to build a deep bench of future shareholders.

The value dislocation caused by Brexit could present an opportunity for these potential investors to initiate a position. However, the bottom-up, stock-specific opportunity could be trumped by a top-down allocation decision to move assets out of a region or a sector. These macro considerations are more important post-Brexit than ever in recent memory, particularly for UK and European companies.

The Ipreo Corporate Analytics team did a deep dive into ownership data preceding the June 23 Brexit vote and immediately after the vote. We reviewed ownership information sourced from the share registers of a majority of the component companies in the FTSE 100 (large and mega caps) and FTSE 250 (mid and small caps). Ownership information from June 1, prior to Brexit, was compared to share register ownership information as of July 1, just after the Brexit vote. Here's what we found.

INSTITUTIONAL ACTIVITY BY REGION

Selling of both FTSE 100 and FTSE 250 companies was widespread. For both sets of companies, investors based in continental Europe and the UK & Ireland were bigger net sellers on a percentage basis than their North American counterparts. From June 1 to July 1, investors in Europe and the UK reduced their FTSE 100 exposure by 2.4% and 1.2%, respectively. North American investors reduced their exposure by 0.6%. For the FTSE 250 companies, which generally have more exposure to the UK economy and less international exposure, selling was even more pronounced. European and UK investors reduced their month-over-month exposure by 4.4% and 4.2%, respectively. North American investors showed a more tempered reaction reducing UK exposure by 1.7%.

Ownership Changes By Region

FTSE 100		FTSE 250	
Investor Region	% Change	Investor Region	% Change
Europe	-2.4%	Europe	-4.4%
UK/Ireland	-1.2%	UK/Ireland	-4.2%
Asia	-0.7%	North America	-1.7%
North America	-0.6%	Asia	4.1%

INSTITUTIONAL ACTIVITY BY SECTOR

Selling by sector was close to across the board with only Energy stocks in the FTSE 100 showing net institutional inflow. Consistent with the qualitative investor feedback highlighted earlier, the largest selling occurred in Consumer Services (-2.4%) and Financials (-2.1%). In the FTSE 250, Consumer Goods and Consumer Services companies were sold even more aggressively, as institutional assets committed to these sectors fell 5.6% and 4.8%, respectively, while outflows from financials totaled 4.1%. The more dramatic ownership changes in the more UK-centric FTSE 250 companies versus the more globally-oriented FTSE 100 companies reflect the negative outlook for the UK economy that immediately followed Brexit.

Ownership Changes By Sector

FTSE 100		FTSE 250	
Sector	% Change	Sector	% Change
Consumer Services	-2.4%	Consumer Goods	-5.6%
Financials	-2.1%	Consumer Services	-4.8%
Technology	-1.7%	Industrials	-4.5%
Consumer Goods	-1.2%	Financials	-4.1%
Industrials	-1.1%	Utilities	-3.2%
Healthcare	-1.0%	Energy	-2.6%
Basic Materials	-0.7%	Healthcare	-2.6%
Utilities	-0.4%	Technology	-2.4%
Energy	0.7%	Basic Materials	-1.3%

INSTITUTIONAL ACTIVITY BY PORTFOLIO TURNOVER

Most investor-relations professionals prioritize the pursuit of investors with low and medium portfolio turnover above investors that churn the stocks in their portfolios on a more frequent basis. Even in a high-impact situation like Brexit, the portfolio turnover traits of these institutions held up rather well. For the FTSE, 100 investors with a high level of portfolio turnover saw an ownership decrease of 4.1%, while investors with portfolios that have medium and low turnover percentages saw outflows of 2.6% and 0.6%, respectively. The FTSE 250 saw a more dramatic change in ownership coming from investors with medium portfolio turnover statistics at -5.9%. Investors with very high and high portfolio turnover did not change their approach reducing their respective ownerships by 6.6% and 5.5%. Most companies prefer and pursue a healthy mix of institutional shareholders, whether that's by turnover, investor type or by region. The reaction to Brexit is an illustration as to why investors with longer holding periods are worth your time. These investors may take longer to make an investment, but their philosophy of holding for the long term will often survive the most trying and uncertain times, making their pursuit worthwhile.

Ownership Changes By Turnover

FTSE 100		FTSE 250	
Turnover	% Change	Turnover	% Change
High	-4.1%	Very High	-6.6%
Medium	-2.6%	Medium	-5.9%
Very High	-2.0%	High	-5.5%
Low	-0.6%	Low	-2.5%

Portfolio Equity Turnover is the measure of how frequently a portfolio buys or sells securities over a 12 month period. It is calculated as the sum of the dollar values of buys and sells over a given period, divided by the sum of the beginning and ending equity assets over the same period, reported as an annualized percentage.

A portfolio with a turnover rate of 100% replaces its entire portfolio throughout the course of a 12-month period, whereas, a portfolio with a turnover rate of 50% replaces half of its holdings during the same time

- Low Turnover (0-33.3% per year)
- Medium Turnover (33.3 -66.6% per year)
- High Turnover (66.6-100% per year)
- Very High Turnover (Over 100% per year)

Next up in our series will be a view of the investors making the largest moves in UK and continental European equities.