Beating the Market THE RIGHT WAY

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Beating the market
THE RIGHT WAY

Jonathan Baliff and **Gregory Milano** report on the quest of the helicopter transportation company, Bristow, to become the safest company and the best performer for shareholders

Can a company be a top performer for shareholders while also being a leader in safety and other important non-financial factors? Many might view this as unlikely because they tend to associate shareholder value with an obsession with short-term profit that often involves squeezing less tangible goals such as safety and corporate culture. They typically think shareholder value means firing workers, slashing costs, selling assets, leveraging up with debt, buying back stock and reducing investments in growth capital.

It can be done. The Houston-based Bristow Group provides a powerful example of how to achieve strong share price performance while delivering safety, quality and other critical non-financial results.

When Bill Chiles took the helm as CEO of Offshore Logistics, later renamed Bristow, in July 2004, the company was already one of the largest civilian operators of helicopters in the world – primarily taking passengers to and from offshore oil rigs. Chiles, who retired as CEO in 2014, was a proud new leader that summer but, during his first year in office, he realised that being one of the largest didn't necessarily mean being one of the best. Many improvements were needed. He led a thorough transformation of the company, which has outperformed almost every member of the Philadelphia Oilfield Service Index (OSX) in recent years.

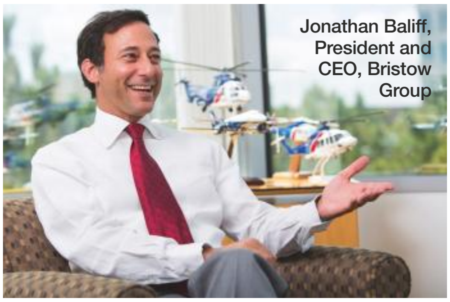
First, safety standards and safety results were inadequate. Flying helicopters is challenging, and management believed better safety practices would benefit employees, clients and shareholders. The company implemented 'Target Zero', an industry-leading programme focused on continuous improvement in safety, which ultimately creates differentiation and customer loyalty. Total recordable safety incidents were reduced from 1.34 per 200,000 work hours in 2006 to 0.68 in 2010 and the figures have further improved since then.

On top of this, the fleet was ageing and many aircraft featured older technology, which increased maintenance costs and reduced client satisfaction and therefore pricing. The company required hefty investments in modern helicopters that could safely carry more passengers to further distances as production and drilling platforms continued to move farther away from shore. The company grew gross fixed assets, consisting primarily of helicopters, by $1.3bn, or 147 per cent, over the five years through 2010.

As if safety inadequacies and ageing aircraft weren't enough, during 2005, management uncovered Foreign Corrupt Practices Act (FCPA) violations, which necessitated swift and comprehensive action. This was quite a challenge for Chiles and his senior management team. After self-reporting the discoveries to the Securities and Exchange Commission and Department of Justice, the company investigated certain improper payments made by foreign affiliates of the company in Nigeria. The matter was resolved in September 2007 without any fine or other monetary sanction upon Bristow.

Adding value

By 2010 Bristow was operating more safely with a modernised fleet and the FCPA violations were fading into the distant past. Customers and employees were better off, but shareholders weren't. An investment in the Philadelphia OSX in January 2005 was worth double a similar investment in Bristow by March 2010.



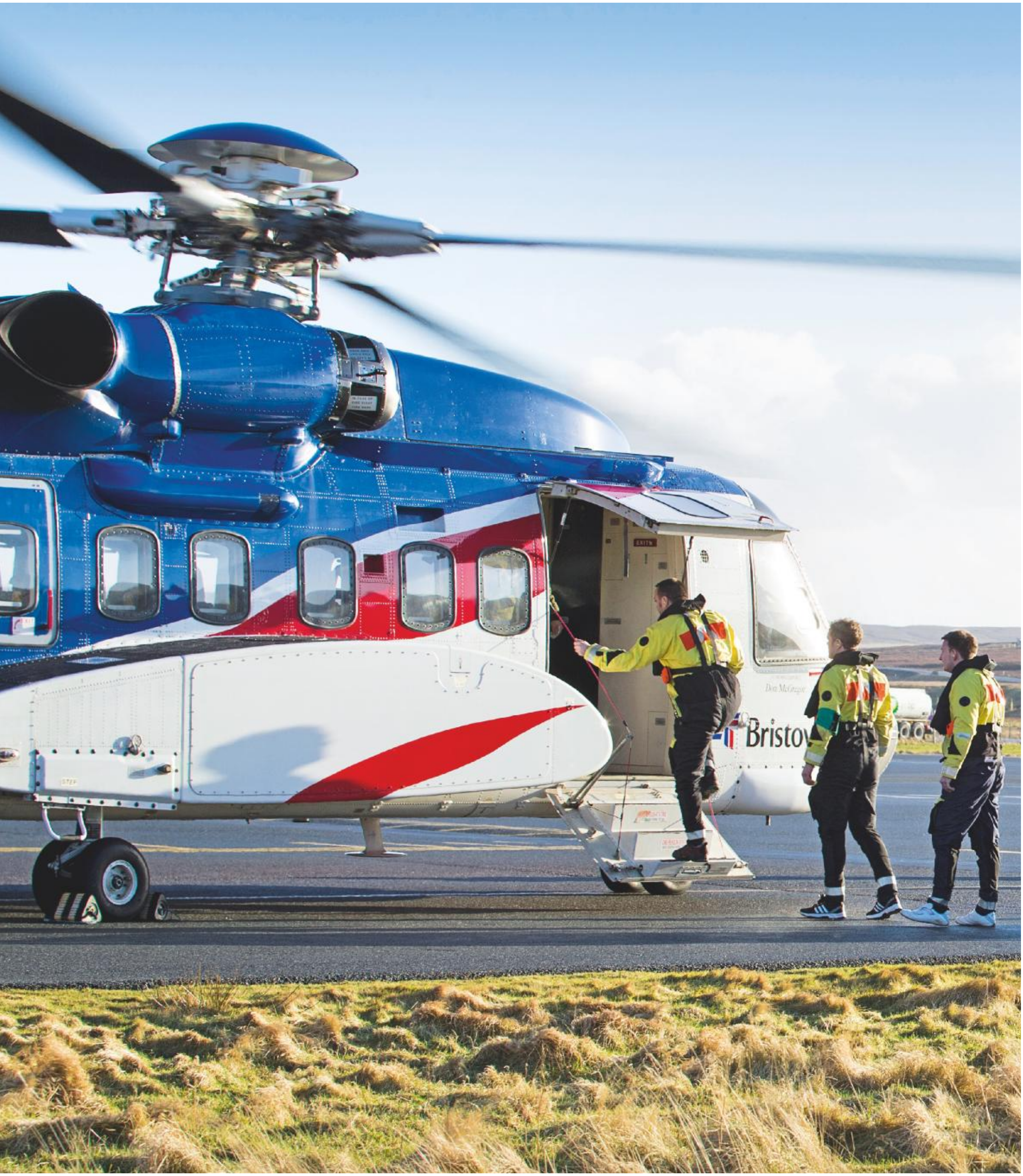
Jonathan Baliff, President and CEO, Bristow Group

At Bristow's investor day in May 2010, management received high marks for its safety record, improved business management practices, candour, openness and overall integrity. But a number of investors and analysts balked at the company's inability to deliver returns above its cost of capital. Management often talked about its barriers to entry so investors wondered why returns weren't higher. It was clear management had more work to do.

Two important catalysts for change occurred later in 2010. First, senior management met to consider the company's vision and strategy for the future. They established a new, more client-centric initiative to provide the safest and most efficient helicopter services and aviation support worldwide. The goal was to promise industry-leading value to clients, employees and, crucially, shareholders, while remaining true to core values.

Second, Bristow decided to measure financial success differently by embracing a customised measure of performance that came to be known as Bristow Value Added, or BVA. The calculation of BVA is straightforward as it measures the company's ability to deliver after tax gross cash flow in excess of covering the required return on the company's gross operating assets. The goal was to implement a metric that would change decision making within the organisation and focus management on reinvesting in the business for the long term and generating returns well above the company's cost of capital. With the assistance of Fortuna Advisors, Bristow embedded BVA in planning, financing, capital investment decision-making, bid pricing, performance measurement and incentives.

Neither management nor the board of directors took the idea of implementing BVA lightly as they were aware of, and in some cases worked at, companies that had embraced a


Bristow

similar measure over the past few decades only to downplay or completely drop it a few years later. Success at these companies was limited by measures that were overly complicated, training programmes that were inadequate, and unforeseen incentives to squeeze old assets, which resulted in underinvestment in the business. The board tasked management with explicitly addressing these issues by ensuring that managers understood (by conducting a company-wide training and implementation of BVA) and used the new metrics so that the company improved its decision making for future investments.

The new metric, BVA, is an improved version of economic profit that explains valuation better and drives superior behaviour by senior management, region management and line management. BVA measures cash flow instead of profit to avoid non-cash depreciation and amortisation distortions and focuses on efficient balance sheet management of receivables and inventory. By determining the capital charge on gross, undepreciated assets, the measure does not incentivise managers to milk old assets that seem free once they are depreciated and encourages underutilised assets to be made available to other operating units. Other aspects of BVA are customised for Bristow to make it both understandable and accurate given the company's business model. As a result, the measure promotes the right behaviour and is relevant to Bristow employees.

With the benefit of these catalysts, over the first three years, from 1 November 2010, when the BVA project began, the company delivered a cumulative total shareholder return of 116 per cent, which is 3.3 times as high as the 35 per cent return of the OSX index over the same period. Shareholders are now better off.

And while delivering this outstanding performance for shareholders, the company further improved safety. Total incidents declined further to 0.26 in 2013, which reflects 81 per cent fewer safety incidents per work hour versus 2005. The company recorded zero incidents for more than 365 days in its oil and gas and search and rescue operations in 2014. And since the BVA project began, the company has invested three times its net income into capital expenditures, primarily for technologically-advanced aircraft. Clients and employees continue to be better off.

Changes for the best

Many things have improved. Inventory turnover has increased and accounts receivable collections have accelerated. Costs have been reduced in numerous areas and underutilised capital sold. Investments were screened and challenged internally to see if they improved the BVA of the company. Through a deep emphasis on operational excellence, both margins and asset utilisation have improved greatly.

The client-centric effort, known as 'the Client Promise,' resulted in numerous improvements to client experiences that help Bristow deliver a premium service offering and be the supplier of choice for its customers, while still resulting in lower total cost to the client. Delivering value to clients begins with safety, which the company believes should be a standard for the industry. The safety culture is so pervasive that when one of the authors visited operations in Aberdeen a random worker saw him on the stairs and said to him, "Stop typing into that phone and hold on to the handrail". Bristow employees mean business when it comes to safety.

Bristow also improved the client experience with newer, more efficient and longer-range aircraft. This required a considerable investment of capital, but with oil being discovered and produced farther away from shore, these state-of-the-art aircraft were needed to bid on new longer term contracts.

> Bristow has reshaped financial policies to support its strategy and maximise its return to shareholders

The efficiency of flight and ground operations was also enhanced by the focus on BVA, which led to more frequent on-time departures and arrivals and better overall customer service feedback. Logistical delays can increase costs to clients when, for example, they have to pay both a crew coming on shift and another going off shift for an extended period. More efficient ground operations benefit the customer and also create a better experience for the worker travelling from home to an offshore work site.

Of course, there were more financially-driven improvements as well. The company had too much capacity, particularly in small, single-engine aircraft in the Gulf of Mexico. Activity levels were down in the wake of the BP Macondo incident, yet the company held on to many assets that were only being flown to maintain certification. There were three obstacles to selling excess assets. The secondhand market was temporarily down and managers felt that if they held on for a while resale values might rebound. In addition, the future of flight in the Gulf of Mexico was murky. And lastly, most managers, at Bristow and elsewhere, simply don't like to part with assets if they think they might someday use them. Since BVA was installed, Bristow has sold 97 aircraft for $167m.

Bristow CEO Emeritus Bill Chiles is the first chairman of HeliOffshore's board of directors


Bristow maintains an extensive fleet of helicopters to carry out its assignments worldwide

The total number of different aircraft models has been cut from 28 to 22 and will be reduced to a target of eight aircraft types over the next five years. This saves on maintenance, inventory and pilot training, and improves the ability to manage the fleet for optimal utilisation. The company has also signed long-term 'power by the hour' maintenance contracts with helicopter manufacturers to ensure availability and lock in maintenance pricing at reasonable levels for an extended period of time.

In addition, Bristow changed its helicopter financing strategy to include a mix of operating leases that allow it to commit to five-to-ten years of an asset's life rather than its whole life. This reduces the amount of upfront capital commitment required and promotes a strategy of upgrading aircraft to newer models periodically without taking the risk of an asset losing its residual value. BVA helped the buy-in to this strategy since, even though the company capitalises the present value of operating lease commitments for BVA purposes, managers quickly figured out they could obtain more new aircraft for the same amount of capital if a portion of them are leased. The company maintains restrictions on how much leasing can be done, but within prudent limits the use of operating leases has benefitted BVA, the company's cost of capital and the share price.

In all, this project has freed up several hundred million dollars of organic cash flow that the company has been able to redeploy into several new high-growth, high-return

Bristow's Target Zero culture of safety is practiced at every level of the organisation

Bristow provides search and rescue services to oil and gas clients worldwide and on behalf of the UK's Maritime and Coastguard Agency

opportunities while strengthening its overall financial position. In addition to the continued funding of the company's core oil and gas transportation operations, Bristow bid and won the privatisation contract for the UK search and rescue (UK SAR) helicopter operations, which provides a new platform for growth and success as well as customer and operations diversification. Bristow also acquired significant ownership in leading operators in Canada and Brazil and now operates in over 20 countries.

In parallel with these operating and investment improvements, Bristow has reshaped financial policies to support its strategy and maximise its return to shareholders. The company began paying a dividend in 2010 and it has doubled the payout in about three years. Another part of the policy of returning capital to shareholders involves selective share repurchases, although management and the board are very careful to buy shares only when the valuation passes certain objective valuation tests. Debt and leases form a higher percentage of total capital than before, but there are strict limits on total leverage and fixed costs and the company maintains very high liquidity.

Behind all of these operating and financial improvements was a transformation of business management to encourage managers to act more and more like long-term, committed owners. They treat the capital of the company as if it were their own money. The commitment of the senior management team to improving BVA has sent a signal across the company that all important decisions should be made based on the impact of both near-term and long-term BVA. And management has demonstrated a willingness to make decisions, as in the case of the UK SAR business, that dilute near-term EPS in exchange for stronger long-term BVA and cash flow growth. It's not about the short-term or the long-term, it's about both. This may seem contrary to the common practices of many US businesses, but management believes and delivers according to it.

The result has been nothing short of a pervasive transformation of how managers think and act all over the company. BVA is universally and comprehensively embedded in how Bristow develops plans, prepares budgets, considers investments, prices bids and measures performance. If you ask any member of management, anywhere in the company, about the financial implications of a decision, the first thing he or she is likely to mention is the decision's BVA implication. This has been reinforced by a serious commitment to BVA in Bristow's compensation plan.

Across corporate America, most bonuses are based on some profit metric compared to a budgeted target value. This is intended to ensure targets are realistic given what is known at the start of the year. This practice unfortunately encourages managers to 'sandbag' their budgets. And true improvements are never rewarded if they are known at the start of the year since they are guaranteed to get baked into the budget. Measuring against budgets ruins both the budget and reward processes.

Bristow experienced such budget problems so the prospect of separating the bonus from the budget was enticing. Management decided to measure BVA, a very robust measure, each year against the prior year. If the company invests new capital, the target for cash flow automatically increases to cover the required return on the new capital. Managers now treat the company's capital much more as if it is their own since any new capital invested that doesn't deliver incremental returns above the cost of capital over time costs them personally. Some of the value they destroy, or create, is their own which has reinforced a culture of ownership.

Although management is very proud of the success Bristow has realised in terms of safety, client satisfaction, fleet modernisation and shareholder value, their focus now is less on what they have accomplished and more on what they want to accomplish going forward.

The top priority, of course, continues to be safety and management is always embracing new technologies and processes that help make both ground and flight operations safer. They are also focused on further improving the client experience through innovations in service delivery. And they intend to improve safety and client experience while driving BVA, cash flow returns and Bristow's share price higher. By achieving on each of these dimensions simultaneously, management plans to continue beating the market the right way.

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