

*Foundation for
Governance Research and Education*

A Charitable Foundation

**Engagement between boards of
FTSE-small cap and FTSE-250 companies
and institutional shareholders**

(Engagement Publication No.1)

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Foundation for Governance Research and Education

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*“Good governance is essential
for a prosperous economy and a healthy society”*

The Foundation for Governance Research and Education, as an independent charitable foundation, is uniquely positioned to identify and objectively analyse key governance issues, and make practical recommendations supported by research commissioned from the academic community.

From its base as an independent authority, the Foundation aims to influence public policy, regulation and the practice of governance.

The Foundation’s Engagement Publication No.1 identifies key issues and makes practical recommendations for engagement between the boards of FTSE-small cap and FTSE-250 companies and institutional shareholders. It also identifies those areas for further research and analysis, the results of which will be the subject of subsequent publications.

Dr John Mellor, Foundation Founder and Executive Director, was responsible for the research and writing of this publication, with the support of the Foundation’s Research Steering Group and additional input from an invited group of company chairmen, investors and corporate financiers.

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Executive Summary

This Publication deals with **engagement** between **FTSE-small cap and FTSE-250** company boards and institutional shareholders, as distinct from disclosure in a company's annual report for analysis and evaluation by shareholders and/or their agents. Whilst both are communication, engagement requires contact and dialogue between the two parties. High quality disclosure (reporting) on the part of companies and effective engagement between companies and their institutional shareholders are essential to the sustainability of the 'comply or explain' basis for the Combined Code.

Engagement, however, can also have a wider purpose, namely the enhancement of shareholder value. This is referred to as active engagement.

The Publication is divided into two Sections. Section 1 focuses on the Key Issues and Practical Recommendations on engagement. These are based on research conducted through meetings with senior and experienced practitioners in the business, institutional shareholder and corporate adviser/broking communities, supplemented by other work. This is presented in Section 2.

The key issues are identified under a series of questions, namely:

- Where does responsibility for initiating engagement lie?
- Should engagement be with the fund manager or governance specialist?
- Where does responsibility for identifying governance issues requiring engagement lie?
- Under what circumstances does active engagement apply?
- Are the incentives for fund managers to actively engage sufficient?
- Are there gains for the fund manager from less active forms of engagement?
- How do small cap portfolio fund managers cope with the large number of investee companies?
- How important is the involvement of chairmen?
- Do company advisers and brokers have a role in engagement?
- What is there to learn from the private equity and hedge fund models?

Thirteen practical Recommendations on engagement are proposed for serious consideration. To that end, further work to progress some of the Recommendations, as well as relevant and associated projects to be initiated, are outlined and included as a final Recommendation.

The Foundation's purpose is to encourage better engagement between the boards of FTSE-small cap and FTSE-250 companies and institutional shareholders by leading the debate on the Recommendations and their implementation - supported by continuing research, publications and forums for discussion.

Section 1 – Key Issues and Practical Recommendations

Key Issues

Engagement requires more than just contact between the parties. It must include dialogue.

In practice there are different degrees of engagement ranging from dialogue to explain a departure from the Code to more active engagement with the objective of increasing shareholder value. Here the dialogue is usually aimed at seeking a change in behaviour and recognises that people are at the heart of governance issues. The dialogue must be a positive and worthwhile experience for both parties, company and institutional shareholders.

1. Where does the responsibility for initiating engagement lie – with company boards or institutional shareholders?

- Arguably with company boards in the first instance because they are naturally most familiar with the company's circumstances. Institutional shareholders should nevertheless be prepared to initiate the engagement. Active shareholders will, as likely as not, take the initiative with companies that are considered to be underperforming, i.e. where there is an opportunity to increase shareholder value or a need to arrest decline in shareholder value.
- However, for company boards to identify those key shareholders for engagement can prove a challenge because of the diversity of types of shareholding arising from today's composition of capital markets and array of investment instruments.
- Engagement should not, on the other hand, be in any sense mandatory. Well run companies, complying with the Code and providing reports of high quality, should not be requested to spend time, and their institutional shareholders time, on engagement where no value would be added. Consideration should be given to reducing the reporting and regulatory burdens for such companies, releasing more time to be spent on managing and growing the business.

2. Should the engagement be with the fund manager or governance specialist? There are some important issues underlying this question, amongst which the most fundamental are:

- There is a need to draw a distinction between fund managers acting as traders, i.e. making the buy/sell decision on the stock, and those more akin to the underlying investor, taking an active interest in the performance of the company rather than simply the day to day movement of the share price.
- The skills required to engage with boards on governance issues are not normally required of fund managers to be effective in their investment role.

There are two remedies, either to ensure that fund managers have the necessary skills, or for fund managers to have recourse to governance specialists with the required skills.

- In either case, in addition to a proper understanding of the company's circumstances, effective and constructive engagement with company board members requires interpersonal, questioning and other behavioural attributes.
- Where there are governance specialists with the required skills, how are they best integrated into the fund management process? Effective integration is necessary to avoid the mixed signals on governance that some companies experience.

3. Where does the responsibility for identifying the governance issues that require engagement lie – with company boards or institutional shareholders?

- Again, for reasons of familiarity with the company's circumstances responsibility must lie mainly with the board. But institutional shareholders should also be prepared to raise governance issues of which the company may be unaware.
- Once governance issues have been identified by the company, the fund manager must be responsive to requests for meetings by the company. This is not always the case. Responsibility is therefore two-way.
- The quality of reporting also has a part to play. The better the quality, the easier the identification of governance issues which require engagement for their resolution. Companies need to be more forthcoming in their governance reports, and institutional shareholders need to be more understanding of explanations.
- To establish a definitive list of key governance issues for companies and institutional shareholders, so as to provide a basis for initiating engagement, is probably unrealistic in view of the variety of circumstances that apply to such a significantly large number of companies in an investment portfolio. However, generically these issues will usually fall into one or more of the following categories: board composition, effectiveness and succession; strategy; risk management; capital structure; and remuneration versus performance.

4. Accepting that in practice there are different degrees of engagement ranging from: engagement to explain Code exceptions to active engagement to increase shareholder value - under what circumstances does active engagement apply? This begs the question of costs versus benefits and may bring into play a threshold for percentage shareholding and/or the value of the shareholding below which active engagement becomes uneconomic.

- Active engagement applies where there is clear opportunity to increase shareholder value. This might arise for a number of reasons of which the need to rectify underperformance is but one.
- That there is an economic case for active engagement is demonstrated by the presence of shareholder activist in the market, and arguably they are behaving as responsible owners insofar as they are working to increase shareholder value.
- On the face of it, therefore, there is a case for active engagement by traditional long-only investors, most probably when their shareholdings are sufficiently material. There is an economic value to such engagement if it is properly targeted. It would appear highly likely that there are particularly appropriate companies for active engagement amongst the small and mid cap quoted sector. Newly listed companies could present especially worthwhile subjects for active engagement, for example.

5. The evidence indicates that active engagement with FTSE-small cap and 250 companies by fund managers is by no means universal. To the extent that there is an economic value to this engagement, this is to the disadvantage of beneficial owners. This raises the fundamental question – are the incentives for fund managers to actively engage sufficient?

- The responsibility for ensuring that the investment mandate agreed with the fund managers provides sufficient incentives to engage rests with the fund's trustees as part of their fiduciary duties.
- In considering incentives and fund manager mandates it is important to take into account that there has been a significant shift from relative to absolute return strategies by the fund management industry in recent years.
- Beneficial owners of shares might reasonably assume that fund managers are engaged, in appropriate cases, to preserve and increase the value of their investments, and that this is included in the management fee.

6. Are there gains for the fund manager from less active forms of engagement?

- This is difficult to establish without further evidence but it might be assumed that, at the very least, some form of engagement is a necessary step to preserving shareholder value.
- Another course is disengagement, i.e. selling the shares, which might trigger the board to take action to rectify the underperformance. But is this responsible share ownership when a possible knock-on effect is a shrinkage of the company, and what that might mean for levels of employment, etc., which could have been avoided?

7. How do small cap portfolio fund managers cope with a large number of investee companies?

- Part of the answer must lie in focussing only on those governance issues that matter and where responsibility lies for identifying those issues is discussed under paragraph 3 above.
- Cost and resource constraints are clearly an important impediment to engagement for small caps, and their institutional shareholders in particular. In some cases the solution for institutions may lie in outsourcing their engagement responsibilities, albeit that there is still a cost involved. Organisations such as Governance for Owners and Hermes Equity Ownership Services (HEOS) provide such a service, but the employment of engagement agents generally appears somewhat limited to date, certainly so far as UK institutions are concerned. HEOS, on the other hand, reports a growing take up of its services by overseas investors such as pension funds.
- The position on outsourcing engagement is in contrast to the more extensive use of voting agencies, such as PIRC, RREV or Manifest, by institutional shareholders. When voting recommendations avoid a 'box-ticking' approach, then a basis for more focussed and time efficient engagement by institutional shareholders is provided. Unfortunately, anecdotal evidence indicates that some voting agencies are perceived as 'box tickers' by many companies.
- Outsourcing of responsibility for engagement by institutions is not widespread and is not sufficiently tested to provide a resolution, or one of the resolutions, to the institutional shareholders logistical problem.

8. How important is the involvement of chairmen in the engagement process?

- The chairman sets the tone from the top on relations with institutional shareholders, but his/her involvement in engagement varies – more active engagement conceivably justifies greater chairman involvement.
- There is arguably a case for chairmen to be more visible in the company's relationships generally with institutional shareholders nevertheless, without upsetting current arrangements. Investor relations, professionally and objectively executed, are an important facilitator of developing contact and engagement between institutional shareholders and the boards of smaller quoted companies.

9. Do company advisers and brokers have a role in engagement?

- Company advisers and brokers should be in a strong position to play a key role in facilitating the engagement between boards and shareholders on governance issues, but the indications are that not enough is being made of this opportunity.

10. What is there to learn on engagement from the private equity and hedge fund models?

- There is probably more to learn from the hedge fund model than the private equity model for engagement with FTSE-small cap and 250 companies.
- Hedge funds, in their activist role, provide evidence for active engagement increasing shareholder value, but typically operate with cost and incentive structures which differ from those of institutional shareholders. This does not rule out lessons to be learned. For example, the skills and experience of successful activists could provide a guide to the level of skills required within institutional shareholders for engagement to be effective.
- However, this is not to completely discard the private equity model as a source of reference. To the extent that private equity investors take corporate governance into account, such evidence as there is indicates that their major concern is with the board, and not least with the mix of skills on the board.

Conclusions

As evidence accumulates to show that active engagement carefully targeted can lead to an increase in shareholder value, the message needs to be reinforced to encourage the fund management industry to take engagement with the boards of FTSE-small caps and 250s more seriously. Engagement to underpin the 'comply or explain' principle in those cases where an explanation for a departure from the Code is required is also important. This too needs dialogue between company boards and institutional shareholders.

It is in the interests of the beneficial owners of shares in companies that opportunities for increasing shareholder value through active engagement are taken by institutional shareholders. Appropriate incentives will need to be included in fund management mandates for this to happen.

However, for this outcome to be realised the important question of incentives based upon meaningful cost versus benefits analysis must be addressed. There is a need for further attention to be paid to this issue and some of the other outstanding issues raised above.

Practical Recommendations on engagement

The recommendations on engagement applying to FTSE-small cap and 250 companies and their institutional shareholders are below. They conclude with a recommendation for further practical research.

- i) Company boards should be proactive in identifying those governance issues which are key to the company's sustainability and to increasing shareholder value in the longer term. They should be prepared to include them on the agenda for engagement, and institutional shareholders should be ready to respond. Companies and their institutional shareholders should maintain focus on these key governance issues.
- ii) Company boards should initiate the engagement in most instances, but institutional shareholders should be prepared to initiate active engagement with those companies where there is an opportunity to increase shareholder value in the longer term.
- iii) Companies should aim to identify and maintain a dialogue with their key institutional shareholders, which typically number around six.
- iv) Chairmen should include a report on contact with the company's major shareholders in their Governance Reports.
- v) The more active the engagement is, the more the chairman should be involved, but In general chairmen should be more visible in the company's relationship with their institutional shareholders without upsetting current arrangements.
- vi) When contact with the chairman is inappropriate, or in his absence, contact should be with the senior independent director. The non-executive directors should not be the point of contact for institutional shareholders for engagement on governance issues.
- vii) Reporting and regulatory burdens should be reduced for well run companies complying with the Code and providing reports of high quality.
- viii) Engagement should not be mandatory.
- ix) Institutional shareholders should ensure that fund managers and/or their governance specialists have the required skills, including interpersonal skills, and level of experience to engage with company board members on governance issues.
- x) Institutional shareholders should ensure that, where engagement on governance issues is the responsibility of governance specialists, they are integrated into the fund management process.

- xi) Institutional shareholders should be prepared to raise governance issues of which the company is unaware.
- xii) Incentives for institutional shareholders to actively engage with companies to preserve and enhance shareholder value should be incorporated into investment mandates.
- xiii) The use of company advisers and brokers to facilitate engagement should be enhanced.
- xiv) Further practical research should be carried out to progress Recommendations vii) – reducing the reporting and regulatory burden, and ix) – institutional shareholders ensuring they have people with the required skills for engagement. Further research is also required on incentives (Recommendation xii). This must be based on sound cost versus benefits analysis, with a view to clearly identifying the criteria (e.g. level and value of shareholding) where active engagement is warranted, and establishing the economic justification for resources devoted to engagement.

In addition, projects should be initiated to:

- a) Explore the feasibility of institutional shareholders outsourcing their engagement responsibilities as a means of overcoming the logistical problem arising from large portfolios of investee companies.
- b) Accumulate evidence to demonstrate the increase of shareholder value (and value to the economy) of active engagement with FTSE-small caps and 250 companies.
- c) Explore the feasibility of detaching Section 2 on Institutional Shareholders from the Combined Code, presenting it as a separate but complementary Code of Conduct against which institutions would 'comply or explain'.

Section 2 – Results and discussion of background research

Starting with a brief description of engagement to set the agenda for what follows, this Section covers:

- Current status of engagement
- Impediments to engagement
- Other perspectives on engagement
- Case study

Description of engagement

There are two aspects to engagement on corporate governance. One is in connection with compliance or non-compliance with the Combined Code and the other with seeking improvements to drive shareholder value. The first aspect could be described as embodying the ‘internal’ or ‘structural’ perspective on corporate governance, and the second the ‘external’ or ‘strategic’ perspective. The second is referred to as active engagement. Both aspects are components of ‘responsible’ ownership by institutional shareholders.

Current status of engagement

1. Overview

The code of conduct which applies to institutional shareholders, the institutional Shareholders Committee’s “Responsibilities of institutional shareholders and agents – statement of principles”, includes guidelines on engagement with company boards. Institutional shareholders are required to adopt this statement of principles, and recent surveys by the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF) (see below) indicate that engagement activity and resources devoted to it are on the increase. However, these surveys are dealing mainly with engagement with boards of the FTSE-350 and can cover ethical, environmental and social issues as well as engagement on governance issues, viz. board structure, composition and remuneration. Scanning a number of institutional shareholders’ engagement policies reveals different degrees of activity and reporting, as well as, in some cases, a particular focus on social and ethical issues. It is clear from this that engagement with the boards of smaller companies, whose businesses are on a different scale to that of FTSE-100 companies in particular, needs to be more finely tuned.

2. Conclusions from Foundation evidence-based research

Preliminary research was conducted by the Foundation (published in 2006) and based on discussions at senior level with companies drawn from the FTSE-small cap and FTSE-250 indexes, and with governance specialists, fund managers and analysts amongst institutional shareholders¹.

¹ See Appendix I

The discussions covered questions on engagement such as:

- i) what are the points of contact between companies and shareholders?
- ii) which elements of the Code take priority alongside other key issues for engagement, such as strategy, risk management, capital structure and dividend policy?
- iii) what bearing might a company's market cap have on engagement activity?

a) Companies

- From the FTSE-small caps point of view, engagement is variable, ranging from good with significant shareholders to merely routine at results time and nothing more. Typically the contact is with the chief executive and finance director (when governance is rarely discussed), with little or no contact with other board members. The overall conclusion is that engagement with institutional shareholders is less than satisfactory.
- FTSE-250 companies on the other hand are more 'on the radar screen' of shareholders (helped by their size and being fewer in number). This gives them an advantage (over small caps) as far as claiming shareholders' attention is concerned.

b) Institutional shareholders

Engagement is, in the main, by fund managers and is best described as 'varied', meaning without any pattern save for two noticeable features – (i) the focus on engagement with the chief executive and finance director, and (ii) no engagement at all, apart from at results time, unless company performance deteriorates, at which point contact is stepped up significantly. Engagement is taken more seriously at the time of the initial investment and lapses thereafter. It is also relevant to note that, for the FTSE-small caps, contact with the chairman and non-executives rarely takes place outside Annual General Meetings.

In general, as far as the Code goes, institutional shareholders are most concerned with company board structure, composition, effectiveness and succession.

3. Ongoing Foundation research – advisers and brokers in engagement

Further research by the Foundation in 2007 has included exploring the role company **advisers and brokers**² play in the engagement process. In the view of one major company adviser -

“Companies need to know and engage with their more important shareholders, typically around six in number. Advisers to companies, particularly those new or relatively new to the capital markets, are in a strong position to play a key role in facilitating this engagement.”

² See Appendix I

Company advisers and brokers would seem to be in a strong position to play a key role in facilitating the engagement between boards and shareholders on governance issues. The very nature of broking has, as the primary objective, the generation of fees by encouraging and facilitating the sale and trading of shares in the client company, and all aspects of the service must, of necessity, revolve around this. At the same time, whilst putting client companies and their shareholders into contact is clearly a part of the service, the evidence for their encouraging this contact to facilitate engagement for discussion of governance issues is not immediately apparent. This may indicate a missed opportunity.

Anecdotal evidence from discussions with institutional shareholders is mixed. Whilst there is a general acceptance that advisers and brokers are in a privileged position to facilitate proper engagement, this evidence indicates that their effectiveness in this regard is patchy.

4. Financial Reporting Council (FRC) Reviews

During September and October 2006 the FRC held a series of meetings with over 40 chairmen of FTSE-250 companies and small cap companies to hear their views on the impact of the Combined Code and other corporate governance matters. Views were mixed on how well 'comply or explain' was working, and on the quality and level of engagement between institutional shareholders and company boards. Agreeing with a conclusion of the Foundation evidence-based research, it is interesting to note that most participants also reported that institutional shareholders showed little or no interest in meeting either the chairman or the senior independent director unless there were problems with the company. The later Review of the Combined Code, published by the FRC in November 2007³, whilst noting an increase in engagement activity by institutional shareholders, nevertheless revealed engagement to still be a point for concern.

5. Investment Management Association (IMA) Survey⁴

In August 2007 the IMA published their fourth survey of Fund Managers' engagement with companies for the year ended 30 June 2006, which indicated improving levels of engagement by their members (UK asset managers) and of resources devoted to engagement. However, for the purposes of this publication, there are two important caveats:

- the small sample size of only 33 member firms taking part in the survey, albeit their funds under management represented 32% of the UK market cap (as measured by the FTSE-All Share Index)
- the investee companies covered are drawn from the FTSE-All Share index and therefore do not provide a sufficiently sharp focus on engagement with FTSE-small caps and FTSE-250 companies

³ 2007 Review of the Combined Code; FRC (November 2007)

⁴ Engagement with companies for the year ended 30 June 2006; IMA (August 2007)

6. NAPF Survey⁵

The NAPF reported on their third survey of pension funds engagement with companies in August 2007. The survey was addressed to large pension funds (more than £1 billion under management) and 39 responded (with combined assets totalling more than £230 billion). This survey also found increasing levels of engagement and resources devoted to engagement, but the same caveats as for the IMA survey above apply – small sample size and an insufficiently sharp focus on engagement with FTSE-small cap and FTSE-250 companies.

7. Hermes UK Focus Fund research⁶

Further useful insights into the engagement activities of shareholder activists can be gleaned from evidence from a “clinical study of the Hermes UK Focus Fund”. These engagements involved contact with chairmen, CEOs and CFOs. In more than half the cases contact was also made with other executives such as divisional managers, heads of investor relations and with non-executive board members. The objective of engagement is to bring about substantial changes to the governance structure of the target companies with a view to enhancing value. Subjects for engagement included re-structuring, board changes, financial policies and, under other policies, improved investor relations for example. The study provided substantive evidence of gains from shareholder activism and suggested that well focussed engagements can result in substantial public returns to outside shareholders as well as those actually involved in the engagements.

Impediments to engagement

Effective engagement, particularly amongst FTSE-small cap companies, is not widespread. This state of affairs could lead to the undermining of the principles-based approach to corporate governance and with it the ‘comply or explain’ basis for the Code if it means that a box-ticking approach to the Code is taken instead. Ineffective engagement is also an opportunity missed on the part of shareholders to work with company boards on improvement and development of their investee company’s corporate governance to achieve sustainability and increase shareholder value.

However, and this applies especially to the small caps which are large in number, there are **cost and resource constraints** on both company and shareholder sides. The issue of costs and resources (including time) is particularly acute amongst shareholders in small caps, given the size of their portfolios which can run into several hundred investee companies. The **incentives** to engage do not appear sufficient to encourage a more proactive approach. Cost versus benefit analysis is needed to gain a better understanding of this, but the Foundation’s research also revealed an attitude of indifference to corporate governance amongst some UK institutional shareholders in smaller quoted companies. There is also some evidence

⁵ Pension Funds’ Engagement with Companies; NAPF (August 2007)

⁶ Becht et al ECGI publication – “Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund” (December 2006)

to indicate that some fund managers are not responsive to smaller companies' requests for meetings. Further, many fund managers focus on performance relative to the Index rather than on achieving superior absolute returns. This reduces the incentive to engage. It should, however, increase the incentive to take an interest in corporate governance standards of the market as a whole.

Other impediments to engagement exist. To the extent that institutional shareholders **outsource their engagement responsibilities to agents** acting on their behalf, the efficiency and effectiveness of these agents is called into account. At present this is a little understood area and therefore a strong candidate for practical research.

Lastly, the **increasing ownership of UK shares by foreign investors** could result in a further impediment to engagement because of unfamiliarity with UK corporate governance, perhaps exacerbated by the distance geographically between the parties. A recent survey on share ownership by the ONS (2006)⁷ showed that investors from outside the UK owned 40% of UK shares listed on the UK Stock Exchange at the end of 2006, up from 36% at the end of 2004.

Other perspectives on engagement

The listed company model runs on the agency principle, where management and ownership of the company are separated. For very large companies the agency principle is tested because of the large number of shareholders. For smaller companies with a smaller number of shareholders the interests of shareholders and management should, on the face of it at least, more easily be aligned to their mutual benefit. This suggests that, in seeking more effective engagement between institutional shareholders and the boards of FTSE-small cap and FTSE-250 companies, it is worth taking a look at the private equity model and the activities of hedge funds (in their shareholder activist role) to see if anything useful can be learnt. In both these cases the number of 'active' shareholders is also small.

1. Private equity model

Institutional investors in private equity are limited partners in funds managed by the private equity firm in their capacity of general partner. Engagement in this model is between the general partner and limited partners in contrast to the listed model, where engagement is directly between institutional shareholders and company boards. Another key differentiating feature of private equity is the short chain of communication between the general partner and the executives of the investee company, facilitating effective engagement (as well as alignment of interests). Typically the general partner has one or more of its representatives on the investee company board.

An objective of engagement is enhanced company value. To what extent does engagement as practiced in the private equity model enhance company value and is this enhancement greater than for the listed company model? The Walker report on

⁷ Source: Office for National Statistics, Share Ownership 2006

“Guidelines for disclosure and transparency in private equity” published in November 2007 launched an industry-wide initiative to assess this enhanced value. Whilst the initiative overall is directed principally at promoting understanding of private equity, the resulting analysis will permit the bench-marking of private equity performance alongside that of quoted companies in the UK in comparable industry or business areas. Preliminary indications suggest that the performance of private equity has been fairly consistently stronger in terms of growth, enterprise, earnings and employment, e.g. a recent BVCA report indicates private equity returns of 20.1% over the period 1997-2007, comfortably beating the corresponding returns for the FTSE-250 and FTSE-small cap indices of 6.2% and 6.5% respectively. Further and rigorous analysis will be required to provide evidence to justify this proposition, why this is so, and what regulatory or other impediments might stand in the way of enhanced performance by quoted companies. This debate centres in particular on the very direct alignment of interest achieved by private equity between ownership and management, an alignment that is at least attenuated in the case of quoted companies by the complexity of regulation designed to protect owners and the integrity of the public market.

Relevant to the comparison with the private equity model is the expected hold period for an individual portfolio company. This is normally well below 10 years and most commonly in the range of three to five years before the general partner exits by means of an IPO, sale to another private equity firm or to a strategic buyer. This holding period is not unlike that practiced by long-term institutional shareholders but considerably shorter than the investment horizons of short term investors.

It should be added that the substantive content and frequency of communication between general partner and limited partner is typically much greater than that between a listed company and its shareholders, in large part because limited partners are committed as insiders and there is no public market for trading in the liquid asset which is the share of the fund held by the limited partner. In general, limited partners are much better informed about the position and performance of portfolio funds in which they have invested than most investors in companies which are listed.

The above provides no clear signals for engagement by institutional shareholders with smaller companies, but it may warrant further consideration. For instance, anecdotal evidence suggests that some private equity investors focus particularly on the mix of skills on the board, which might provide a useful benchmark for smaller company governance.

2. Hedge fund model

The striking comparison between (traditional) institutional shareholders and hedge fund activists is that the former typically engage ex-post and the latter ex-ante. Kahan and Rock⁸ suggested that –

“mutual fund and pension fund activism, if it occurs, tends to be intermittent and ex-post: when fund management notes that portfolio companies are under-

⁸ Kahan and Rock “Hedge Funds in Corporate Governance and Corporate Control” (University of Pennsylvania Law School, July 2006)

performing, or that their governance is deficient, they will sometimes become active. In contrast, hedge fund activism is strategic and ex-ante; hedge fund managers first determine whether a company would benefit from activism, then take a position, and then become active.”

What we are dealing with here is active engagement by hedge funds seeking to increase shareholder value. The hedge fund engagement agenda can include seeking changes to a company’s governance structures or processes⁹, and also :

- Influencing board and management decisions about the company’s capital structure and its use of capital.
- Influencing the company’s operational strategies.
- Intervening in the market for corporate control (e.g. calling for a company to put itself up for sale, supporting or opposing a proposed takeover or merger).

Managers of activist hedge funds identify companies that present high value opportunities for engagement. Various researchers have tried to identify the factors that appear to attract engagement by activist hedge funds. Frequently mentioned factors include the following:

- Size of company – the smaller the market capitalisation of the company, the lower the volume of the investment needed. On the other hand larger companies are increasingly becoming the subjects of engagement as hedge funds increase the value of their assets under management and therefore have sufficient capital to invest large sums in larger companies.
- Cash rich companies.
- Companies with low leverage.
- Companies with a poor share price performance.
- Perceived discrepancies between company asset and market values.
- Management/governance weaknesses. Interestingly enough, however, for activist hedge funds, weak management and governance processes and structures are relevant but not sufficient reasons in themselves to select a company for engagement. In addition, there must be short to medium term opportunities to realise an increase in long term value.
- Excessive premiums on proposed acquisitions – if market participants conclude that the company is proposing to pay too much for another company or other asset the stock price of the proposed acquirer is likely to fall, thereby attracting activists who now consider the acquired stock to be under valued.

What, therefore, might be learned for engagement with FTSE-small cap and FTSE-250 companies by institutional shareholders from the hedge funds in their activist role? First, the incentive is increased shareholder value, suggesting that engagement brings an economic benefit. Second, engagement is more nearly a continuing activity (for as long as the shareholding exists). And, thirdly, the focus is on those governance issues which are relevant, in the particular circumstances of the company under consideration, for sustainability and the increase of shareholder value.

⁹ OECD Steering Group on Corporate Governance - “The implications of alternative investment vehicles for corporate governance” (July 2007)

Case Study

Wyevale Garden Centres (Wyevale)¹⁰

Wyevale is presented as an example of active engagement which resulted in increased shareholder value.

Founded in 1961, Wyevale is the UK's leading independent garden chain. The company has been the pioneer in the garden chain sector from its original site in the 1960s and modelled itself on trends from the US. Having grown organically to 14 sites, the company listed in 1987 to fund its growth and make acquisitions in a fragmented industry. Subsequently the company completed a series of acquisitions, culminating in the purchase of major rival Country Gardens in 2000.

The company was delisted in May 2006 upon acquisition by a consortium led by West Coast Capital, the investment vehicle of retail entrepreneur, Tom Hunter. The last full year results as a listed company showed sales of £193million, generating a pre-tax profit of £15million (for the previous year pre-tax profit was £21million on sales of £190million).

Hermes, through its UK small companies focus fund, became an investor in Wyevale in December 2003, buying in at 338.5p per share. In total Hermes then held 5.5% of Wyevale's share capital and cited a number of reasons why, in their view, the shares were at a discount to fair value. These included:

- i) poor governance,
- ii) over payment for acquisitions
- iii) investor confidence at a low because of a series of profit warnings
- iv) losing focus as a specialist retailer
- v) outmoded retail skills
- vi) weak financial discipline and insufficient focus on shareholder value

The company had a history of poor investor relations and of limited engagement with their investor base.

The engagement programme initiated by Hermes and promoted to both executive and non executive members of the board over a long period of time, began with a meeting and presentation of the issues to the chairman in April 2004. It may be summarised as follows:

1. To establish a succession plan at chairman level.
2. To construct a programme for the sale of under performing stores, many sitting on highly valuable freehold edge of town sites, to release significant capital for investment in refurbishment of the remaining stores.
3. To examine the capital structure with a view to establishing and articulating a clear capital allocation strategy.
4. To strengthen the executive management team at board level.

¹⁰ The Foundation wishes to express its thanks to Hermes for suggesting and assisting with this case study.

5. To support the future acquisition of large stores where much higher returns could be earned from being in more powerful destinations.

In the event, the then chairman stepped down and a successor was appointed. A new chief executive, chief operations officer and marketing director were also introduced to drive change.

Continuing support for the board based on an ongoing dialogue with the new chairman, particularly over the months leading up to the bid by West Coast Capital, ensured a successful outcome. After buying in at 338.5p per share, the consortium led by West Coast Capital acquired Wyevale for 555p per share, representing an increase in shareholder value of some 64%.

SOURCES

COMPANIES

Small Cap Quoted Companies

Alexandra	Dyson Group	Keller Group
AVEVA	Easynet Group	Nord Anglia Education
Axon Group	Erinaceous Group	Phytopharm
Blacks Leisure	Fuller Smith and Turner	Ricardo
Brandon Hire	Huntleigh Technology	Umeco
Chemring	ICM Computer Group	Unite
Dart Group	James Fisher & Sons	XAAR

FTSE 250 Companies

Electrocomponents
Go-Ahead
Greggs
Renishaw
Rotork
VICTREX
Weir Group

INSTITUTIONAL SHAREHOLDERS

Fund managers / analysts

Hermes
Gartmore
Foreign & Colonial
Co-operative Insurance Society
Schroders
Close

Governance Specialists

Hermes
Gartmore
Foreign & Colonial
Co-operative Insurance Society
Insight (HBOS)
J P Morgan Fleming
Barclays Global Investment
Legal & General
Railpen

'Activists'

Governance for Owners
Hermes Focus Fund

/ continued ...

COMPANY ADVISERS / BROKERS

Teather & Greenwood
Panmure Gordon
Brewin Dolphin
Charles Stanley Securities
Grant Thornton
Ospara (adviser to Hedge Funds)

Also reviewed

JP Morgan Cazenove
KBC Peel Hunt
Evolution Securities
Collins Stewart
Hoare Govett
Seymour Pierce
Numis Securities

OTHER BODIES

National Association of Pension Funds
Association of British Insurers
Quoted Companies Alliance
British Venture Capital Association
London Stock Exchange

WEBSITES INVESTIGATED

International Corporate Governance Network
European Corporate Governance Forum
Organisation for Economic Cooperation and Development
European Corporate Governance Institute

The Foundation wishes to thank all those who contributed through discussion with Dr Mellor.

APPENDIX II

FOUNDATION RESEARCH STEERING GROUP

Dr John Mellor	Foundation - Founder and Executive Director
Professor Ian Percy	Foundation - President and Trustee
Chris Hodge	Financial Reporting Council - Head of Corporate Governance, and Foundation Trustee
Guy Jubb	Standard Life Investments UK - Head of Corporate Governance
John Pierce	Quoted Companies Alliance - CEO
David Spence	Institute of Chartered Accountants of Scotland Research Committee - Chairman
David Styles	Department of Business Enterprise and Regulatory Reform – Asst. Director Corporate Governance & Europe

APPENDIX III

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