STRAIGHT FROM THE SOURCE
BRINGING TOGETHER DIRECTORS AND INVESTORS

HUGESSEN CONSULTING

STEVEN HALL & PARTNERS EXECUTIVE COMPENSATION

In December 2015, Hugessen Consulting and Steven Hall & Partners hosted a Director and Investor Roadshow in NYC, bringing together experienced North American directors and representatives from US institutional investors ($7 trillion in AUM) for a day of unfiltered discussion on a variety of executive compensation and governance topics.

This event provided an opportunity for:

- Directors to hear first-hand about the key priorities of major institutional shareholders and their varied approaches to governance,
- Shareholders to hear directors' perspectives on board matters, including how they weigh business implications and market challenges, and
- Directors and shareholders to build connections across their respective communities

At a high level, the views of participants were remarkably consistent between the shareholders and directors. However, as the conversation delved deeper into certain topics, it became apparent that differences of opinion do exist (among shareholders and directors, and between the two groups). These differences tended to surface with regard to emerging governance topics and compensation nuances, where high level principles need to be augmented by case-by-case considerations.

We summarize below select themes from the event:

Shareholder Engagement

Consensus view among both director and shareholder participants was that shareholder engagement is a positive trend in the evolution of corporate governance. Directors stated that they are becoming more involved in engagement and there was recognition that this involvement allows for direct, private, and candid discussion, while reducing the influence of advisory firms as it "eliminates the middleman with no skin-in-the-game." While director involvement is not always necessary (situation-specific), shareholders noted that directors should be familiar with their top 20 shareholders and have a high-level understanding of their approach to governance (e.g., active/passive investing, voting with proxy advisors vs. having their own guidelines, etc.).

Executive Compensation – Performance Metrics and Link to Strategy

Both directors and shareholders agreed that before a company can develop effective executive compensation plans, it must develop a cogent strategy, often "an elusive art". All agreed that pay should be linked to successful execution against the strategic plan and to building company culture. Some shareholders expressed concern that issuers are adopting increasingly similar pay programs as a result of Say-on-Pay and proxy advisor influence, either real or perceived. In particular, an overreliance on metrics like EPS (easy to manipulate) and TSR (a performance outcome that can not be directly controlled by management) indicate to some a lack of effort in developing effective pay design. Shareholders said they will support a diverse range of performance metrics provided they understand the underlying rationale, including alignment with the business plan and link to long-term value creation.

Board Renewal

Board renewal was an important topic to both groups, with consensus agreement that independence of thought and diversity of skills and experiences amongst directors are critical. Directors agreed on the importance of a board renewal plan but balked at the idea of term limits or diversity quotas. One commented that "constructing a board of directors is less a scientific endeavor and more of an art." Shareholders generally agreed that regular, rigorous board assessments are preferable to arbitrary thresholds, but noted that from the outside it is hard to determine if such assessments are being done. In the absence of compelling disclosure, one shareholder noted that "no fresh face in four years" raises questions about the board's renewal planning and suggested that it may be better to temporarily increase board size to ensure refreshment and manage succession rather than be faced with multiple exits at one time. Directors stressed the importance of institutional knowledge provided by longer-term directors.

Capital Allocation

Capital allocation is a key focus for shareholders and is often included as a top engagement topic. Shareholders appreciate returns of capital when they make good business sense, but stressed that they must be balanced with prudent reinvestment and the company's long term strategy and sustainability. One director commented that boards are increasingly focusing on capital expenditures versus returning capital to shareholders noting, "you go back to the reason you gave to investors to buy the stock in the first place and then you honor that". Shareholders cautioned directors against paying too much attention to short-term activist investor calls for share buybacks and other returns of capital, noting that directors should be able to rely on their long-term shareholders for support.

Conclusion

Although it is still early days for shareholder engagement, both shareholders and directors found the session to be extremely productive. It offered a unique opportunity to interact without having to address a specific issuer, creating an open forum and healthy exchange of ideas. We expect to see more of this type of interaction in the future, coinciding with the increasing importance of the relationship between Boards and shareholders.