

Back the best *'...and dump the rest'*

Firms which are properly run, where risk is managed effectively and management's interests are aligned with those of shareholders, are likely to be better portfolio picks in the long run, as Russ Mould explains.

A

nyone who thinks corporate governance is a boring subject and one an investor can simply ignore needs to think again.

Just ask Tony Hayward, former chief executive officer (CEO) of **BP (BP)**. He presided over one of the worst oil spills in history in the Gulf of Mexico, a development which cost his firm at least \$20 billion and Hayward his job, due to perceived failings in the handling of safety issues. Just ask investors in **Connaught (CNT)** who have seen the value of their shareholdings collapse amid multiple profit warnings, debt covenant breaches and (as yet unconfirmed) market talk of a Financial Service Authority

inquiry into whether management had failed to disclose potentially price-sensitive information in a timely manner. And just ask those shareholders in **Marks & Spencer (MKS)** who caused a rumpus at the firm's Annual General Meeting (AGM) last month (14 Jul) when they voted against what they considered to be excessive executive pay packets by refusing to approve the retailer's remuneration report.

As many a professional fund manager will tell you, sometimes the job of racking up portfolio profits is as much about avoiding the disasters as it is digging out the next ten-bagger. Nobody should back a firm with their own hard-earned cash without doing some research in to just how well run a company really is.

To help investors measure how a company's governance and management track records stack up, *Shares* therefore has not only talked to several experts in this field but also compiled



a simple checklist, designed to help you sort out the smooth operators from the dodgy dealers. In addition we have highlighted **Chemring (CHG)**, **Eaga (EAGA)** and **ITE (ITE)**, three firms whose governance record merits investment, as well as one – **BP (BP)** – where sufficient improvements may be on the way to the benefit of a downtrodden share price.

Good governance

The seemingly-unrelated issues of corporate culture and execution of strategy, transparency and disclosure and remuneration highlighted by BP, Connaught and Marks & Spencer all come under the umbrella of ‘corporate governance’. They may look like ‘soft’ issues in comparison to key considerations such as how much money a firm is making, how strong is its balance sheet or how cheap or expensive it looks, in absolute and relative terms.

But good governance is not just about how much risk a company is taking and how much management is paid to take on and control that risk in the quest for shareholder value. How well a firm’s underlying business is doing and how the market chooses to evaluate its prospects will ultimately dictate the direction of a firm’s share price. But those factors in turn will reflect a host of different issues, including the skills and experience of a company’s entire board, how well the company handles events and delivers news of them to the market and even how the management team relates to and works with its shareholders. Best practice should lead to top-quality strategic decision making and operational excellence.

The tricky bit is that examples of good governance tend to be as visible as a good referee is in a well-managed football or rugby match – you do not tend to notice they are even there, because all has gone so smoothly. It is only when something goes wrong do corporate governance issues come under scrutiny, as in the case with **Rok (ROK)**. The building services firm fell 45% to 16p in just one day last week (11 Aug) following a profit warning, the departure of the finance director and revelations of ‘serious failings of financial controls’ in its plumbing, heating and electrical arm.

The Financial Reporting Council UK Corporate Governance Code: Main principles

- A Leadership:** The board’s collective responsibility, need for a strong chairman and good non-executives
- B Effectiveness:** Board should offer broad range of skills, should receive information in a timely manner and be appointed and reappointed in a transparent way
- C Accountability:** Maintain risk management and control systems, transparent internal reporting and offer a balanced view of firm’s prospects
- D Remuneration:** Pay should attract quality board members and reward performance but not be excessive
- E Relations with shareholders:** There should be a satisfactory dialogue with shareholders, who should be encouraged to attend the AGM

Source: www.frc.org.uk

Investors’ good governance checklist

- 1. Non-executive directors.** Look at the balance of the board - executive vs. non-executive
- 2. Management skills.** Look at the mix of skills and experience on the board
- 3. Non-executive directors.** Look at the independence of the non-executives: have they been there (too) long? Are they adding value?
- 4. Non-executive pay.** Look at the incentivisation of non-executive directors: are they aligned with shareholders and appropriately remunerated?
- 5. Executive pay.** Look at how appropriate is the executive remuneration package
- 6. Committees and controls.** Look at what committees the company has in place and how often they meet
- 7. Advisors.** Look at the record of Nominated Advisors (Nomads) and financial advisors, particularly for overseas and emerging market stocks
- 8. Listing.** Look at where a firm has listed - Premium or Standard listing on Main Market, Aim or PLUS - and why
- 9. Shareholders.** Look at who are the major shareholders, what influence they have and how they vote
- 10. AGMs and EGMs.** Find out when shareholder meetings take place and be prepared to attend

Source: Dorsey & Whitney, *Shares*

Firm guidance

Governance standards have been laid down and influenced by a number of reports and regulatory initiatives, as well as the law.

- The 2003 paper *Review of the Role and Effectiveness of Non-Executive Directors*, more commonly known as the Higgs review, focused on how the importance of high-quality non-executive directors (NEDs) and their role in ensuring too much power does not end up in the hands of any one board member, particularly the CEO.

- The 2006 Companies Act, which replaced the 1985 version, finally fully came in to force in October 2009. It redefined what a director’s duties are, placing an emphasis on corporate social responsibility and offering seven codified tasks (see ‘Directors’ duties according to the 2006 Companies Act’, page 17).

- In 2009, *A review of corporate governance in UK banks and other financial institutions*, or the Walker Report, recommended greater scrutiny of board decisions. That review was launched in the wake of the collapse of Northern Rock and losses which engulfed **Royal Bank of Scotland (RBS)**, both of which were run by CEOs who were perceived to be domineering, Adam Applegarth and Fred Goodwin.

- Last year also saw a review of the UK Corporate Governance Code. An updated version was issued in May by the Financial Reporting Council (FRC) and came in to effect as of June. The document can be accessed on the FRC’s website, www.frc.org.uk. Investors should note the 40-page document does *not* represent a strict set of rules but rather five key principles which form the



The legal view

'I have never met a director of a public company who doesn't take his responsibilities seriously,' says Matthew Doughty, whose considerable experiences of initial public offerings, and mergers and acquisitions makes this a most reassuring insight. 'There is so much legal and reputational risk at stake, including criminal sanctions, that for a director to mislead shareholders has extremely serious implications'.

The Higgs and Walker Reports, as well as the Financial Reporting Council's UK Corporate Governance Code, all have a role to play in establishing the ground rules, but the law firm's partner is quick to stress UK legislation must also be taken into account. 'In the eyes of the law, and in particular the Companies Act, all directors, executive and non-executive, have equal liability. Either you are on the board, or you are not'.

One of Doughty's key roles as a lawyer is to explain to management teams what is expected of them, particularly if a firm is about to list and become a public company. This should ensure a chief executive officer never has to come up before the beak.

'There is a requirement on us to ensure management understands their responsibilities from a corporate governance perspective,' he explains. 'For Aim-listed firms we are required to give an opinion to the Nomad (on a board's understanding of the Aim rules). This is something we take very seriously. For an IPO (initial public offering) I would expect to give a presentation to the board on what corporate governance regulations mean for them.'

'This is not a box-ticking exercise, it's not one size fits all,' Doughty continues. 'The UK Corporate Governance Code is the gold standard in Europe, maybe even the world. Firms have to comply if they want a Premium listing on the Main Market. I am hearing lots of institutional investors are much less keen on companies seeking a standard listing because there is no requirement for them to comply with the governance code. For that reason, you are likely to see these companies volunteer to comply with the code even though technically it is not required. On Aim what we tend to see is firms saying they aspire to meet the code – but that not all elements of the code are appropriate given their size and stage of development.'

Many investors are often suspicious of companies being brought to market by private equity (PE) firms, taking the view all the juice has been squeezed out of them before they are sold on once more. Yet putting these valuation issues to one side, Doughty argues this overlooks how many PE-backed firms are primed and ready for life as a public entity, citing former 3i (III) inmate **Telecity (TCY)** as an example.

'A lot of rigour will have been applied to a firm by private equity and it will come to market already used to reporting to external investors,' says Doughty. 'Private equity will also often retain a stake and therefore a seat on the board. The PE board member will not be independent but at least he will have a huge degree of familiarity with the business and will understand its market.'



Matthew Doughty practices in the London office of international law firm Dorsey & Whitney as a partner in the Corporate Group. He has advised on national and international public equity transactions around the globe and is also a member of the London Stock Exchange's Aim Disciplinary Committee.

basis of a 'comply or explain' approach which lies at the heart of UK corporate governance today.

'The Governance Code and its development was a business-led initiative, and is not a statutory code in the way the Companies Act is,' explains Dick Newby, head of corporate social responsibility at public relations giant Financial Dynamics.

Shares has outlined the five key guidelines in a simple table (See 'The Financial Reporting Council UK Corporate Governance Code: Main principles', page 15). Each one can be assessed simply and they help provide the basis for our easy-to-follow ten-point plan (See 'Good governance checklist' page 15), designed to show investors how to quickly form a view on any company's governance record.

Leadership

Many overweening, ambitious CEOs have been blamed for taking their firms on the road to ruin. The last market bubble to burst was credit, and when that went it took the reputation of Royal Bank of Scotland's Fred Goodwin with it, as the downturn left his acquisition of ABN Amro looking horribly mistimed. The prior bear market, of 2000 to 2003, saw former heroes such as John Mayo of the UK's Marconi (formerly GEC) and Bernie Ebbers of Worldcom in America become zeros. They were vilified for presiding over a corporate collapse in the case of the former, following an acquisition spree, and accounting fraud in the latter.

The FRC's governance code argues a strong, independent chairman and good NEDs are required on a board to stop this from happening. Stuart Rose of Marks & Spencer took on the positions of both chairman and CEO and this became an issue when the recession hit, profits began to wobble and the firm's dividend was cut in both 2009 and 2010. Meanwhile firms such as **Morrison (MRW)**, **BAT (BATS)** and **Sainsbury (SBRY)** are given credit by the market for the independence and abilities of their chairmen, Ian Gibson, Richard Burrows and David Tyler respectively.

'Look at the banks, where there were dominant CEOs,' says Michael Cahill, a former equity analyst and author of the book *A guide to making the right investment decisions: How to analyse companies and value shares*. 'Good governance would have made for better decision making, and that needs good-quality thinking and good-quality debate. What happens is too many CEOs think they are paid to know the answer. It's really about being comfortable about not knowing and having the right people to deal with that.'

A firm's PR can play a role here, according to Financial Dynamics' Dick Newby. 'If a company has a strong CEO he will tend to identify himself with the company, it's a fact of human nature. A PR that's really looking after its clients will need to draw the attention of the CEO to the market's perception he is taking on too much risk.'

Effectiveness

Tony Hayward had to step down as head of BP when the Deep Water Horizon disaster left him in a seemingly untenable position. His replacement, Bob Dudley, has

Directors' duties according to the 2006 UK Companies Act

1. To act within their powers and abide by articles of association and shareholders
2. To promote the success of the company
3. To exercise independent judgement
4. To exercise reasonable care, skill and diligence
5. To avoid conflicts of interest
6. To not accept benefits from third parties
7. To declare an interest in a proposed transaction with the company

Source: www.opsi.gov.uk/acts/acts2006

already stated he wants to shake up the firm's culture and improve its safety record after its third major accident in five years. Any firm's board should offer a broad range of skills but BP's is noticeable for the absence of any real experts in the field of safety (see *Opinion, Shares*, 15 July), barring three NEDs from the healthcare, food and aerospace industries respectively.

In addition, strong and clear internal reporting mechanisms are vital, so management can handle and act upon fresh information as swiftly as possible, and also disseminate their message to staff clearly.

'My observation of what went wrong at BP is not that BP

was bad on safety but it had not observed the distinct differences in culture between 'old' BP and 'new' BP, the businesses it had bought,' says Mark Goyder, a founder director of think tank Tomorrow's Company. 'In both Texas City and the Gulf of Mexico, they found standards [of safety] that horrified senior BP management.'

Michael Cahill picks up this point. 'Governance is all about values embedded in the culture of an organisation, not box ticking. It's all about risk – if you haven't got it the risks are higher. Are you cutting costs or corners? Have you the right values in place to drive behaviour? It can sound pious, and I don't want it to, but it's about integrity.'

Accountability

Managers are there to create shareholder value, but there is a risk too many executives, and particularly CEOs, believe this simply involves getting the share price to go ever higher by any means, whether it is a flurry of press releases, string of acquisitions or the constant production of a series of contrived earnings surprises.

'We can all talk about the quarterly or interim earnings number, but surely we all have to be a bit better than that?' grimaces Michael Cahill. 'That's not shareholder value, which, for me, is generating the returns that compensate you for the risk you are taking [as an investor]'.
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'Business is too conformist on how you create shareholder value,' agrees Goyder. 'Management's job is not to conform to market expectations, its job is to throw the market open and



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'Boards of a listed company should be asking themselves what is our mandate? What are we here to achieve? Boundaries of strategy and territory should be laid down and once they are clear they should provide the base upon which management and shareholders can make their investments. If **Prudential (PRU)** had had such a clear mandate and understood the boundaries it would not have embarked on a path that was seen as a betrayal by its shareholders [with its failed attempt to buy AIA].'

'If you play the 'beat-the-numbers' game, at each stage there's a governance failure - look at Enron,' says Cahill. 'Each move was a step away from what it had stood for as a utility. I can't imagine **Apple's (AAPL:NDQ)** Steve Jobs worrying about the next quarter's earnings. He'll be thinking about its product roadmap for the next five or ten years.'

Remuneration

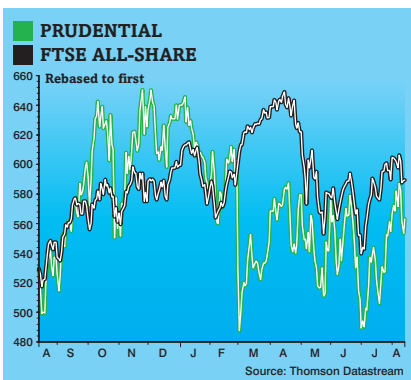
Very few subjects stir investor passion as much as executive pay, as the ruckus over the pension packages handed over to

failed bosses such as Fred Goodwin and Tony Hayward proved. Marks & Spencer is another firm to have raised the ire of its shareholders, 8.63% of whom voted against the company's remuneration report at its AGM in July.

Boards need to offer attractive pay to ensure they get good-quality people, but the trick is how to structure their packages so the firm's long-term strategy is not sacrificed on the altar of near-term share price appreciation, particularly at groups where management has been awarded lots of stock or stock options.

The issue of equity compensation applies to NEDs too, although different nations approach this in varying ways. 'In the UK, the view is the truly independent non-executive should get no equity compensation, because if he does, he might be more focused on short-term performance than shareholder value,' explains Matthew Doughty, law partner in the Corporate Group at international law firm Dorsey & Whitney. 'The American view is it is right to align the interests of NEDs with shareholders.'

'There is lots of risk, regulatory, reputational and legal [with the NED role]. Straight cash is not enough and some



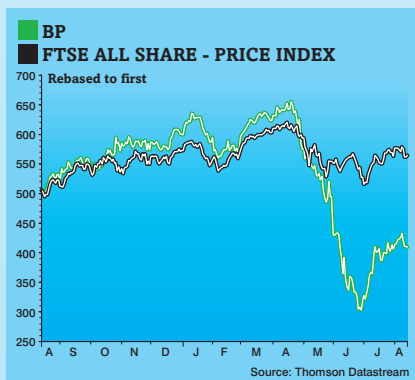
BP (BP.) 405p

+ BUY

Incoming chief executive officer (CEO) Robert Dudley has already promised changes in BP's culture and its safety strategy and perhaps this, along with changes in the composition of the firm's board, is the biggest buy signal.

The oil giant's 2009 report and accounts made it crystal clear just how seriously the firm took the issue of risk management. Yet it was interesting the 14-strong board in place at the time - CEO Tony Hayward has since stepped down to be replaced by fellow executive board member Dudley - featured just one person from the food industry, one from aerospace and one from healthcare - areas where mistakes can result in fatalities.

The absence of individuals from the rail transport, nuclear power or airline businesses is intriguing, since safety is paramount here, too. Fresh blood would perhaps help change market perception of the £77 billion cap after three high-profile accidents in the USA in five years. BP is financially sound, despite the need to set aside \$20 billion in an escrow account to cover costs related to the Gulf of Mexico oil spill, and it looks cheap on a prospective price/earnings ratio of just 5.8 for 2011. (RM)



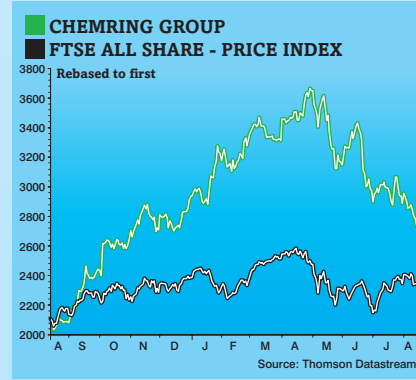
Chemring (CHG) £28.07

+ BUY

The defence firm has an excellent record in managing the challenges of maintaining good corporate governance in an industry not necessarily known for its transparency.

On an annual basis, the managing directors of each of its businesses report to chief executive officer David Price on compliance with the company's *Code of Business Principles*. This document includes commitments on issues such as health and safety, corruption and conflicts of interest. A well-defined whistleblowing policy also gives confidence the group is unlikely to fall foul of the corruption charges or safety failures that have, for example, faced its larger peer **BAE Systems (BA.)** in recent years.

Chemring is a world leader in countermeasures (military decoys) with a rapidly growing footprint in energetics (explosives, cartridges, grenades and disposal of improvised explosive devices). Weakness in the wake of solid rather than spectacular interim numbers (22 Jun) has created an opportunity to buy at a good price, with the stock trading on ten times next year's consensus forecast earnings. (TS)



want equity upside. Corporate governance is becoming ever more high profile and ever more onerous. Being an NED is not a soft sinecure’.

Relations with shareholders

A classic example of how an overbearing CEO could have, but failed, to learn from what the market was telling him was Richard Fuld, who was at the helm of US investment bank Lehman Brothers when it went down in 2008. Fuld refused to engage with hedge fund manager David Einhorn. The Greenlight Capital man had gone short Lehman stock yet Fuld declined to find out why – which looked particularly bad when the money manager turned out to be accurate in his analysis.

Tomorrow’s Company’s Goyder has little truck with many hedge fund managers, or indeed any investment institution which is short term in its outlook, but he is a strong advocate of management engagement with the market.

‘Whether you are listed or not, we think firms need a core of long-term, stable shareholders, maybe with a stake of around 15%,’ asserts Goyder. ‘This should be enough for a company to relate to and to be challenged by when management is under pressure to give in to fashion.’

Financial Dynamics’ Newby has a slightly different take. ‘It’s not a good mentality to say the short-term does not mat-

ter. That’s the real judgement call and it needs a very confident CEO to stick to a long-term strategy when there is short-term pressure in the market, which may even be to the benefit of the company.’

This prompts Goyder to argue the concept of stewardship of the company should extend not just to its management but its shareholders, too. ‘One of the issues we have to come to terms with is whether a company law that says all shareholders must be treated the same is fit for purpose. We should be asking what are their intentions toward a company, and whether companies should be obliged to spend time courting those holders who have no stewardship intentions.’

Goyder was therefore delighted when the FRC published in March of this year a Stewardship Code for investors, to ensure a better dialogue between money managers and companies and also improve corporate governance by getting shareholders to be more active and effective policemen.

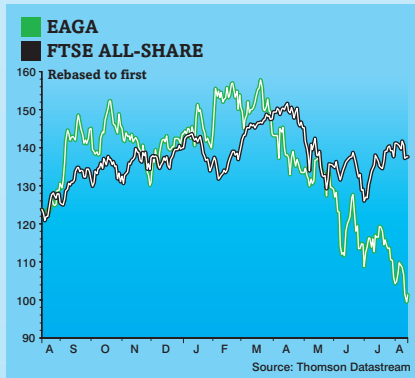
Time to choose

Making a judgement call on how well any company addresses issues can help you protect your wealth by avoiding potentially damaging corporate blunderings and share price disasters. Better still, it can help you latch on to the nation’s best-run firms, whose management has carefully aligned its interests with yours in pursuit of long-term shareholder value creation.

Eaga (EAGA) 102.1p

+ BUY

Public sector-focused companies need to be transparent on trading and their finances, given risks to contract timings amid government spending cuts. As a firm with a strong corporate governance ethos, investors should look toward



Eaga (EAGA) as one set to survive and thrive.

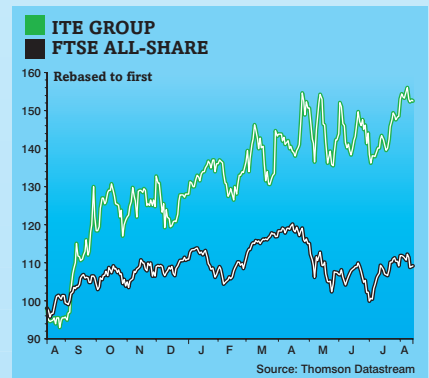
Shares in the Newcastle firm have fallen 35% since March to 102.1p, amid speculation that Warm Front, the government’s fuel poverty scheme administered by Eaga, will be scrapped in March 2011. Lack of progress on Eaga’s plans to install solar panels on social housing, and collect a renewable energy generation fee, has not helped either.

House broker Brewin Dolphin calculates Eaga is worth 105p excluding Warm Front and solar ventures. Yet it believes Warm Front will soon be extended and Eaga will get funding for the solar initiative, both major share price catalysts. Eaga has the right approach by keeping investors updated, having reported seven times in the past year. The management team is well respected and Eaga has committees which regularly meet to oversee finances and risk management, remuneration and also staff, to ensure the company has the right people for the present and future. (DC)

ITE (ITE) 150.9p

+ BUY

Exhibitions group ITE (ITE) is a good example of how a company’s potential can be fulfilled once the correct corporate structure is in place. We like the £378 million market cap given exhibitions is an area with strong recovery potential for 2011 combined with the fact it is exposed to the fast-growing emerging market of Russia (see *Griller*, 11 Mar)



Yet the story could have been very different were it not for a major boardroom clear out in 2002 overseen by current non-executive chairman Iain Paterson. He bought in fresh blood and removed long-entrenched board members, some with links to the company back before its 1998 flotation and who were ultimately responsible for a very disappointing first few years as a public entity. By the end of Paterson’s first year, ITE had a new chief executive officer (CEO) and finance director, the latter then being Russell Taylor, the current CEO, who describes some of his board predecessors as ‘self-interested barons’. Since Paterson’s appointment investors have seen a six-fold rise in the shares from 25p to 150.9p and there could be more to follow. (SK)