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Corporate Governance Should Not be a Numbers Game

SAVANNAH RESEARCH REPORT

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ABOUT THE AUTHOR

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Damian has enjoyed an international career spanning more than 30 years. He started his career as a Chartered Accountant with Ernst & Young in Australia and subsequently held global roles in New York and London, where he now lives. Damian was headhunted by one of the largest global executive search firms in 2013 but has now chosen to work in the boutique environment of Savannah Group. He has advised on appointments to the boards of FTSE 100, FTSE 250, AIM, Euronext, ASX 40 and TSX listed companies and large privately held companies. Damian has a deep interest in corporate governance and leadership.

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0 | EXECUTIVE SUMMARY

Traditional approaches to corporate governance are too often a box-ticking exercise and a distraction from the success of UK PLC. Good governance is a function of the competence and relevance of the individual directors and their effectiveness as a team.

Standards of corporate governance are currently measured and reported in a way that does not correlate with shareholder returns, the key measure of corporate success.

Corporate governance is an increasingly contentious and sensitive topic. Gender diversity, ethnic diversity, executive pay, board representation for employees, chairman tenure, social values, etc. are all sensible and important areas of concern but the way we measure and report on "good" corporate governance is still largely a box-ticking exercise that is becoming a distraction to the real objective of long-term success, the primary objective of the UK Corporate Governance Code.

We are not the only ones concerned by this. The Investor Forum in its 2017 review noted that "too many companies and investors are taking a box-ticking approach to compliance" and companies are reluctant to choose to 'explain' rather than 'comply'".

We have completed a study that clearly shows there is no correlation between "good governance" and total shareholder return and, unless we address this soon, there is a major risk that the FTSE 100 will continue to underperform its global peers. The problem is not what we are measuring but what we are not. Our objective is to challenge the compliance-based thinking and to open a discussion about how to properly assess and safeguard good governance for the long-term success of a corporation for the benefit of all stakeholders. Shareholder groups in particular, but also boards themselves, need to change their approach and focus on what really matters to corporate success but they must do this in a way that is sensitive to relevant social issues or face government intervention. In this context, there were thirteen corporate governance related reports published in 2017, eight of which came from the UK Government or the FCA. It will be a disaster if the "comply or explain" model disappears and quotas become more important than quality.

Our initiative was prompted by a ground-breaking study by the financial advisory firm, Ondra. Their detailed study exposes and documents the critical underperformance of the FTSE 100, in terms of total shareholder return ("TSR"), since the turn of the century. Ondra links this underperformance to a number of factors including **"board composition and governance, particularly non-expert board leadership"** over this period. Our study seeks to complement this work by highlighting the disconnect between so called "good governance" and shareholder returns.

The most comprehensive survey of governance standards in the UK is conducted by the Institute of Directors ("IoD"). Their 2017 Good Governance Report names and ranks the UK's largest listed companies by reference to a Good Governance Index score calculated through a complex scoring process, identifying five categories of corporate governance and 47 "key indicators of good governance". It builds on the 2015 and 2016 reports in a commendable effort to examine the standard of corporate governance at the surveyed companies. However, intuition alone suggests the conclusions are questionable. Is Diageo really the best governed company in the UK? And is GSK, which ranks last at 103rd, down 64 places from its 2015 score, really the worst governed company in the UK? Looking at it from the other perspective, the top performing companies in the FTSE 100 in terms of shareholder returns are ranked well down in terms of governance and a number of them attract the ire of the proxy advisors!

The IoD survey measures and reports on compliance with some important governance factors but that does not provide a meaningful assessment of how effectively those corporations are governed. The pressure to conform with what is measurable is increasingly a distraction from boards' effectiveness in carrying out their fundamental obligation to promote the long-term success of their companies for the benefit of shareholders and other relevant stakeholders.

The Investor Forum's 2017 Review states that their "experience in engagements over the last three years has highlighted how often board effectiveness is called into question" and noting that "it is critical for boards to demonstrate how they discharge their responsibilities effectively". Investor expectations of directors is on the rise.

To put a framework around our concerns, we partnered with the data analytics firm BJSS and calculated the TSR of those companies listed in the IoD 2017 survey. We looked at three periods, from 2000, from 2010 and from 2015. The latter corresponds to the three years in which the IoD has been conducting its Good Governance survey. We found there is no correlation between the good governance rankings and shareholder performance in any of these periods.

But this only really tells us that how we measure "good" corporate governance is wrong or at least lacking key elements. Even the IoD itself recognised the historical graveyard of high profile corporate failures that might have looked good on paper from a governance perspective but "failed to deliver good governance in a more substantive sense". The IoD 2017 survey was published before the high profile collapse of Carillion (and in any case Carillion was not FTSE 100) but there is another example of a company that ticked the governance boxes but was not well governed in a "substantive sense".

So, what is missing? Governance standards cannot be determined by reference to absolute measures of average age, gender, nationality, numbers of meetings, pay ratios, etc. without also considering the three most important elements of good governance:

1. The competence of individual board members;
2. Their relevance to the board; and
3. Their effectiveness as a team.

These may be qualitative concerns but that does not mean they can be ignored or that we should shy away from addressing them, linking the skills of the board to the long-term strategic ambitions of the company. In all of this, the critically important role of the chairman is obvious, and the importance of that appointment cannot be understated. In Bill Clinton's campaign terminology, **"It's the chairman, stupid!"**

OUR STUDY – GOOD GOVERNANCE & SHAREHOLDER RETURNS

While correlation is not causation, we would expect to see over the long term that the best governed companies are producing total shareholder returns higher than the less well governed companies. And no doubt they do. But the best governed companies can't be identified in the way that the IoD has gone about this. And we can illustrate that clearly. With our data analytics partner, BJSS, we calculated the total shareholder return (TSR) of the companies listed in the IoD survey over three periods.

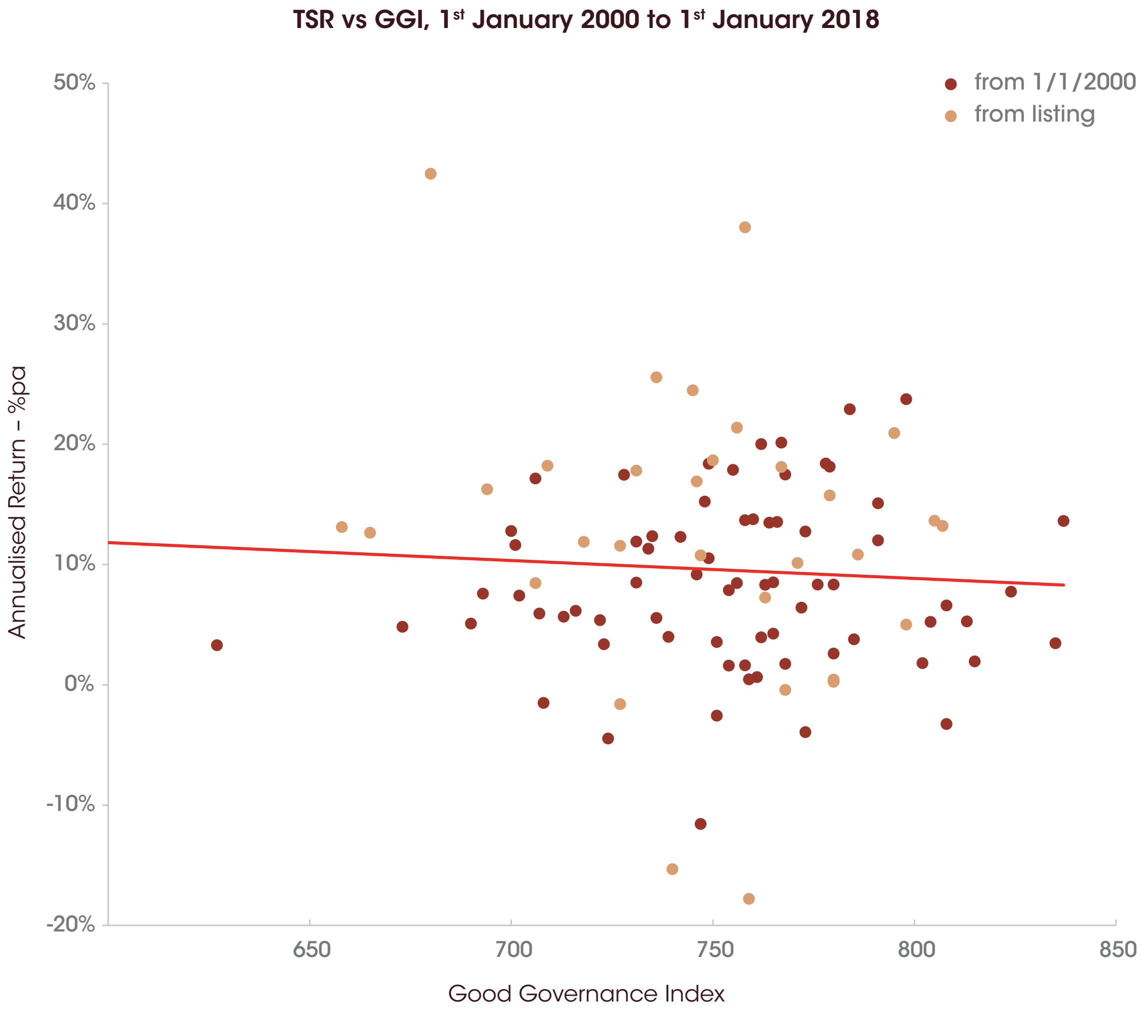


Figure 1. Data analysis provided by BJSS

2000 TO 2018

The first test calculated the annualised TSR for each company between 1 January 2000 to 1 January 2018. For companies not listed at 1 January 2000, we have calculated the TSR for the period starting with their listing date. We then plotted the results against the IoD's Good Governance Index, as shown in figure 1.

Each dot on the chart above represents a company and its Good Governance Index score (GGI) on the horizontal axis and their annualised TSR over the period on the vertical axis. The red line is the "line of best fit" – a line that roughly goes through the middle of points in the data and drawn such that there is an even distribution of points either side. It is used to identify the relationship and strength of correlation between values. In this case, we see clearly that shareholder returns do not depend on, or correlate with, the good governance ranking as the line of best fit is near enough horizontal. Indeed, a more detailed analysis shows us that both the top ten and the bottom ten companies in TSR terms have an average GGI ranking around the midpoint. Over this period, the top ten companies from a shareholder return perspective have an average ranking of only 47 out of 103 while the bottom ten ranked not far away at 55 in the IoD survey.

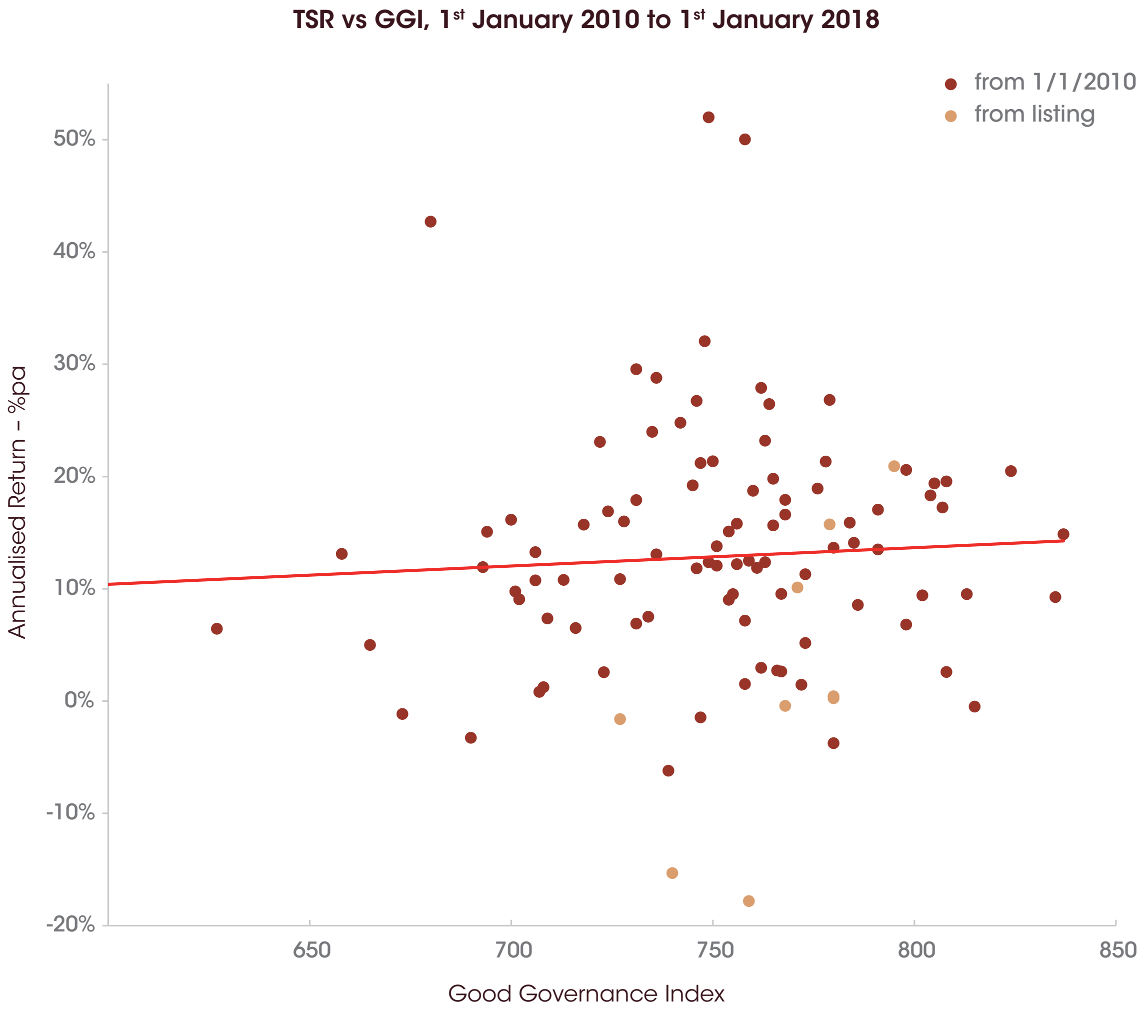


Figure 2. Data analysis provided by BJSS

2010 TO 2018

We ran the test again using a shorter period, 1 January 2010 to 1 January 2018, post the global financial crisis. The results were the same, a seemingly random distribution around the chart (figure 2).

Again that the best fit line is near enough horizontal. Over this period, the top ten companies from a shareholder return perspective are positioned, on average, even further down the good governance rankings than in the first test, falling to an average ranking of only 59 out of 103.

We recognised a potential limitation in the above analysis, so we employed a third test.

2015 TO 2018

The IoD published its first Good Governance survey in 2015 and we are able to track changes in rankings from the 2015, 2016 and 2017 reports. Because the FTSE 100 is a dynamic index, there are companies included in the 2015 report that fell out of the FTSE 100 and others that came into the index during that period. From a TSR perspective, three years is a short period but in order to ensure we were covering all the bases we tested this against the 2017 GGI rankings and found exactly what we found above, no correlation.

Most interesting during this period, however, was the swings in the governance rankings but this is probably down to the IoD's changed methodology rather than anything else.

Table 1. Full List of TSR vs GGI Scores By Company

TSR Ranking	Company	GGI Index Ranking	Annualised Shareholder Return 1 Jan 2000 to Jan 2018
1	ASOS	98	42.5%
2	Melrose	51	38.0%
3	Hargreaves Lansdown	72	25.6%
4	Paddy Pwr Bet	67	24.5%
5	Randgold Resources	12	23.7%
6	British American Tobacco	19	22.9%
7	Micro Focus	53	21.4%
8	Tui Ag	14	20.9%
9	Antofagasta	36	20.1%
10	Croda International	44	20.0%
11	Intertek	59	18.7%
12	DCC	26	18.4%
13	Ashtead Group	60	18.4%
14	Investec	87	18.2%
15	Persimmon	25	18.1%
16	Admiral	35	18.1%
17	Imp.brands	54	17.9%
18	London Stock Exchange	75	17.8%
19	Weir Group	34	17.5%
20	Next	79	17.5%
21	Reckitt Benckiser	91	17.2%
22	Mondi	66	16.9%
23	Burberry	95	16.3%
24	Direct Line	21	15.8%
25	Smith(Ds)	63	15.2%
26	Associated British Foods	15	15.1%
27	Bunzl	46	13.8%
28	Babcock	50	13.7%
29	Intercontinental Hotels	10	13.7%
30	Diageo	1	13.6%
31	Bhp Billiton	37	13.5%
32	Berkeley Group	40	13.5%
33	Intl Consol Air	8	13.2%
34	Carnival	101	13.1%
35	Whitbread	94	12.8%
36	Smith & Nephew	28	12.8%
37	G4S	100	12.6%
38	Barratt Developments	73	12.4%
39	St.James Place	68	12.3%
40	Unilever	16	12.0%
41	Rio Tinto	76	11.9%
42	Experian	84	11.9%
43	Rolls-Royce	93	11.6%
44	Fresnillo	78	11.6%
45	Scottish & Southern Energy	74	11.3%
46	Hikma	18	10.8%
47	Easyjet	64	10.8%
48	Johnson Matthey	61	10.5%
49	Cocacola Hbc Ag	31	10.1%
50	Severn Trent	65	9.2%
51	Ferguson	38	8.5%
52	Schroders	77	8.5%
53	Royal Dutch Shell	90	8.5%
54	Astrazeneca	52	8.5%
55	RELX Group	27	8.3%
56	Shire	23	8.3%
57	Legal & General	41	8.3%
58	National Grid	56	7.9%
59	GKN	3	7.7%
60	BAE Systems	96	7.6%
61	United Utilities	92	7.4%
62	Std Life Aber	42	7.3%
63	Prudential	6	6.6%
64	Provident	30	6.4%
65	HSBC	85	6.2%
66	Morrison	89	5.9%
67	CRH	86	5.7%
68	Old Mutual	71	5.6%

TSR Ranking	Company	GGI Index Ranking	Annualised Shareholder Return 1 Jan 2000 to Jan 2018
69	Taylor Wimpey PLC	83	5.4%
70	Smiths Group	5	5.3%
71	Compass	9	5.2%
72	Standard Chartered	97	5.1%
73	Smurfit Kap.	13	5.0%
74	Anglo American	99	4.8%
75	Informa	39	4.3%
76	Tesco	70	4.0%
77	BP	43	4.0%
78	Rentokil Initial	17	3.8%
79	WPP Group	57	3.6%
80	Aviva	2	3.5%
81	Marks & Spencer	82	3.4%
82	Glaxosmithkline	102	3.3%
83	Centrica	20	2.6%
84	Barclays	4	2.0%
85	Kingfisher	11	1.8%
86	Sage	33	1.7%
87	Sainsbury	49	1.6%
88	3I	55	1.6%
89	Vodafone	45	0.6%
90	Sky Plc	48	0.5%
91	Polymetal	24	0.4%
92	Royal Mail	22	0.3%
93	Merlin Entertainments	32	-0.4%
94	Pearson	88	-1.5%
95	Glencore	80	-1.6%
96	BT	58	-2.6%
97	Royal Sun Alliance	7	-3.2%
98	Lloyds	29	-3.9%
99	ITV	81	-4.4%
100	Royal Bank of Scotland	62	-11.6%
101	ConvaTec	69	-15.3%
102	Mediclinic International	47	-17.8%

ABOUT OUR METHODOLOGY

1. The Total Shareholder Returns are based on "Adjusted Closing Prices" from Yahoo! Finance. Adjusted Closing Price is the closing price after adjustments for all applicable splits and dividend distributions.
2. Yahoo! does not calculate the adjusted closing price correctly for Worldpay Group. We have therefore excluded Worldpay from our analysis.
3. The returns have been calculated from 1 January 2000 / 1 January 2010 or the earliest date information is available on Yahoo! Finance. We have assumed this earliest date is the date the company was listed.
4. The lines of best fit have been calculated using linear regression which is also known as the Ordinary Least Squares (OLS) method. The lines of best fit in Test 1 and Test 2 have a shallow slope. Statistical tests indicate that these slopes are not statistically significant. In other words, the slopes are likely to have occurred with high chance if one were to assume there is no relation between the Good Governance Index (GGI) and Total Shareholder Return (TSR).

2 | SO, WHAT IS MISSING?

The compliance-based measurements, or "box ticking", fails to give any insight into the real issue of board **effectiveness**.

The IoD's survey is scoring companies based mainly on compliance with absolutes - gender; combined CEO/chairman; director's age range; ratio of audit/non-audit fees; % of CEO remuneration in stock; a policy for this, a policy for that. But to measure the real governance standards and the effectiveness of boards requires an assessment of the competence of the individual directors, their relevance for the particular role, and their effectiveness as a team. Competence will include not only the qualifications, experience and track record of the individual in their particular area of expertise but also their understanding of the role and their commitment to it. It will include their ability and preparedness to contribute to the board discussion, to challenge constructively and, importantly, to listen. The esoteric but observable qualities of "style" and "fit" are also important.

Relevance means exactly that. The individual board members must be relevant to the company they are governing and even perhaps at a particular point in the company's life cycle. Industry expertise may or may not be important depending on the functional expertise and the diversity of thought that the chairman requires to best inform effective decision making but industry understanding will always be important in managing the key drivers of success. It is always easier to approach this from the "clean sheet of paper" perspective where a chairman can determine the qualities, skills and competencies he or she needs from the board then do a gap analysis of the current board. Relevance then becomes much clearer.

But ultimately, it is the ability of this team of competent, relevant individuals to work effectively together for the common purpose of long term success. Trust and respect will be critical but, like an orchestra, the team needs a leader who can draw out the required contribution, with appropriate emphasis, at the right time.

And that brings us to the chairman.

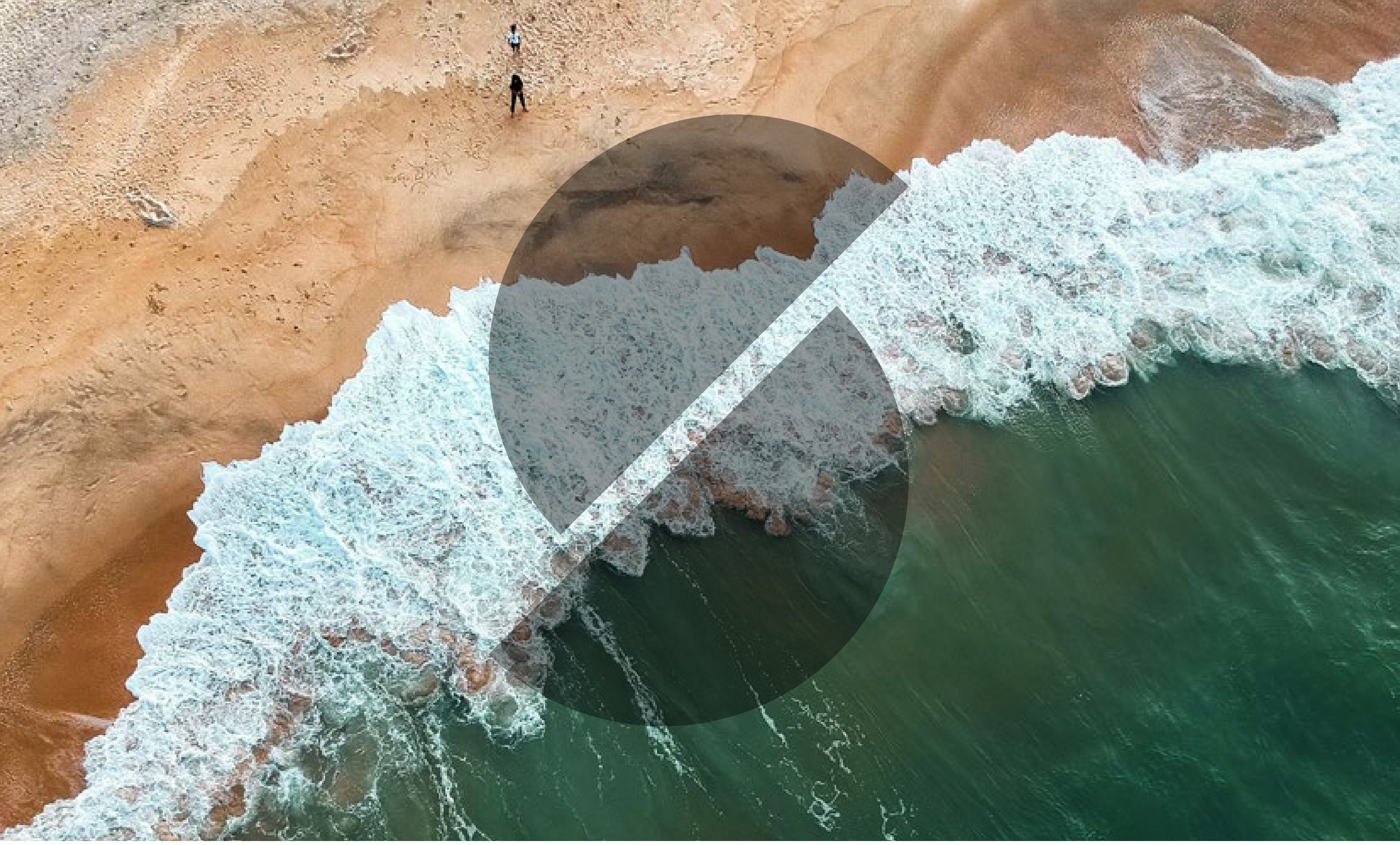
3 | THE CHAIRMAN IS THE LINK

It is the chairman who leads the selection and, critically, de-selection of the board's members and the competence and relevance of each of the men and women invited to join the board will ultimately be the chairman's responsibility. The chairman is also responsible for the effective working relationship of the directors, proper structure (committees, etc.), processes and agenda of the board. The Board appoints the CEO who, in turn, appoints the management team and drives the culture of the organisation. The board and management agree the strategic direction of the company and the board oversees the execution of that strategy.

> "The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role."
>
> **UK Corporate Governance Code**

The chairman's relationship with the CEO – that balance between mentor and employer – and their mutual respect will be a major influence in the successful execution of strategy. And his/her ability to conduct this orchestra of many parts through a complex manuscript will largely determine the effectiveness of the board – and the effective governance of the company.

One of Ondra's key findings in their analysis of the underperformance of the FTSE 100 was the "non-expert board leadership" of those companies. The separation of the chairman and CEO roles gained momentum following the Cadbury Report in 1992 and over the last 20 years it became commonplace to appoint chairmen with no expert knowledge, or even connection to, the industry or sector in which their companies operated. There is no clear rationale for this other than perhaps to ensure there could be absolutely no question about the separation of roles. Chairman skills go well beyond just sector expertise but it must be a challenge for a chairman without the relevant sector expertise to lead a board though strategy development and oversight of its execution. Interestingly, we are now starting to see the pendulum swinging back with some key appointments announced in recent months.



4 | BOARD EFFECTIVENESS

A good chairman is key to an effective board. The annual evaluation of board effectiveness and particularly the external evaluation required by the Code every three years, provide valuable moments for boards to reflect. But the internal evaluation is a subjective analysis, often used as an opportunity to confirm that the boxes are ticked – committee structures, attendance, etc. – rather than a qualitative examination of the competence and contribution of individual non-executive directors and their effectiveness as a board.

Unless the board members are prepared to be brutally honest about themselves, about each other and their collective performance and are prepared to act on their findings, the outcome of any self-examination process is always going to be questionable. External reviews at least provide an opportunity for an "independent" party to facilitate the evaluation. However, when engaged directly by the chairman, objectivity may be questioned. True independence would be a distinct advantage and it might be different if the independent review was commissioned directly by, and reported directly to, the shareholders rather than the board. The Investor Forum partly provides this independent function for its shareholder members but does require the cooperation of the board and is often single issue focused. There are, of course, some very good external review organisations and a good chairman will know how to use this process effectively. Again, it is in the shareholders' best interests to ensure they have a good chairman!

> "Good boards are created by good chairmen. The chairman creates the conditions for overall board and individual director effectiveness."
>
> **Financial Reporting Council – Guide on Board Effectiveness**

5 | BOARD RENEWAL AND DIVERSITY

Perhaps an honest review of board effectiveness might stimulate a broader programme of board renewal, creating more openings for the many very talented, well qualified individuals vying for relatively few available board positions.

In 2017, the FTSE 350 made only 297 new appointments (i.e. not including promotions/changes amongst sitting board members). Reflecting the international nature of the London listings (particularly amongst the FSTE 100), only 186 (63%) of those appointments were British nationals (71 females; 115 males) of which 68 (36%) were first time appointees, 41 males and 27 females.

There are currently almost 2,300 non-executive directors on the FTSE 350 boards and just over 30% of these are females. In many respects, this is an achievement. The FTSE 100 has responded strongly to the gender diversity challenge with 40% of the British appointees in 2017 being female and over 60% of the first timers (i.e. those with no previous FTSE 350 board experience) being female. The FTSE 250 lags these numbers with the corresponding percentages being only 37% and 35% but still an achievement for the proponents of gender diversity.

But gender diversity remains a serious challenge which is exposed by the very few women amongst the executive director ranks. To date in 2018, there have been 58 executive director appointments of which only 6 are women (5 at FTSE 100 companies and only 1 amongst the entire FTSE 250). The talent pool from which to draw well qualified female non-executives must be fed from the executive ranks or we risk over-boarding the current female NEDs putting governance standards at risk.

There is no conflict between the FRC's direction that "board and succession plans should be based on merit and objective criteria" and the Government's diversity aspirations provided good and effective governance is at the forefront and that means that all non-executive directors must be competent and relevant for the particular role. Bringing more females through the senior executive ranks will help deliver this. And this is the board's responsibility. Government intervention and quotas would be failure.

6 | OUR CONCLUSION

As we worked our way through this detailed analysis, it became clear to us that the IoD's methodology did not provide an evaluation of governance as the foundation of corporate success. It effectively defined "good" in the context of "compliance" with some added tweaks. Their evaluation of the governance standards of the UK's largest listed companies was an evaluation of what is measurable, mostly directly. High scores do not reflect good governance and certainly not effective governance. Effective governance, starting with a good chairman and competent, relevant non-executive directors, will best protect and enhance shareholder returns.

Shareholders and their proxy advisors need to understand this difference and to focus on ensuring the companies in which they invest are effectively governed.

ABOUT SAVANNAH GROUP:

Savannah Group is a global executive search and interim management firm specialising in board appointments, functional C-Suite appointments and key-sectors. Wherever businesses are on their transformation journey, we empower business leadership teams by helping them acquire proven leaders that enable and deliver short-term and long-term transformation.

Founded in 2002 and rebranded as Savannah in 2017, more than 600 of the world's leading brands have chosen to use us and 85% of our revenue is from repeat business.

ABOUT BJSS:

Founded in 1993 and with offices across the UK and USA, BJSS is an award-winning privately held Technology and Business consultancy. Our innovative Enterprise Agile® approach has been recognised by the Queen's Award for Enterprise and enables organisations of all sizes to deliver business value from IT transformation.

In today's increasingly data-driven world, competitive advantage is enabled by exploiting the undiscovered value in business data. By applying lean, agile delivery principles we help organisations create solutions that deliver actionable insights.