INTEGRITY WITHOUT COMPROMISE

DURLER CONSULTING

TALENT DEVELOPMENT SOLUTIONS

Durler Consulting Limited

The findings of a report commissioned

by

Durler Consulting

“NON- EXECUTIVE DIRECTORS – NO LONGER AN AFTERTHOUGHT
But
WHO REALLY RULES THE BOARDROOM?”

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EXECUTIVE SUMMARY

A recent study by Durler Consulting of how and why board appointments are made within AIM listed companies and how directors' performance is judged has revealed that the motivation for non-executive director appointments is no longer "all about smoke and mirrors".

It shows that the need for proper, accountable and transparent corporate governance, is overwhelmingly recognised as having made non-execs essential for public companies. This view was underpinned by one company director who stated: "whether or not we like it, corporate governance is now a duty not a choice."

Further, the real value of non-executive directors was recognised by both groups; particularly their experience, independence, leadership qualities and the provision of added credibility and new contacts. Their expected term of service ranged from a minimum of three years to "indefinitely".

However, there was a wide divergence of opinion between companies and the City as to which has ultimate control of board membership, structure, and performance measurement. Board members mainly identify themselves as the decision makers, but advisors and institutional investors predominantly disagree and see this as a joint activity. Indeed, some institutional investors recognized themselves as the final arbiter. Out of a broad consensus two extremes emerged regarding director appointments and removal:

- **One chairman decided when a director was appointed and whom, basically on the premise that he liked them.**
- **The managing director of an investment company observed "in the final analysis, if trust and empathy ceases to exist, and ultimately if they don't act in accordance with shareholder wishes, they go."**

Financial Advisors, Brokers and Funding Bodies

Durler Consulting, a firm of specialist executive search consultants, has undertaken a study of how board appointments are influenced and made within companies quoted or seeking quotation on the Alternative Investment Market (AIM) of the London Stock Exchange.

The study focused on two groups: first, the companies, second, financial advisors and providers of investment funding - including nominated advisors brokers and investment funds. All respondents within both groups were at Chairman or main board director level.

Without exception, responses from executive directors made little reference to the views of their professional advisors or investors, except performance judgment "by share price"; whereas the investor and professional advisor group perceived themselves to play a major role in identifying and influencing the need for board change, and applied criteria far wider than "share price" judgement.

Investment decisions – what comes first, the board or the financials?

In terms of investment decision making, the investor/advisor group were asked a series of nine questions focused on identifying their views of, and perceived influence on, board structure and abilities. The opening question sought to identify, in relation to an investment decision, ***“how much weight is given to the board room team and how much to a company’s “financials”?”***

It was within this element of the study that a major division of opinion occurred. Institutional investors almost without exception took the view that “the board room team is the most important”, adding that the team must demonstrate dedication and belief, market knowledge and experience, in addition to having a clear and profitable business plan and also demonstrate the ability to drive the business forward after the investment phase. This was expanded by the Chairman of one City based investment house who stated:

> “If the board knows its business, is highly ambitious, and inspires confidence we are more likely to invest. If it is not strong on the financial side, we can deal with that; indeed that might suit our purposes. Establishing strong financial controls is not rocket science.”

The above view was echoed almost verbatim by a senior partner of the client investment arm of a leading accountancy firm.

The most extreme opposite view was expressed by an investment broker who stated: “I read the executive summary (of a business plan) then turn to the financials. If they don’t add up I don’t meet the board – financials are everything.”

Others concurred that “the financials are all important to the investment decision” and one observed that “however inspired and expert the board members are, if they do not understand financial systems and controls, we can’t take them seriously and will not invest in them for our clients.”

Question two asked *“how often respondents needed to recommend strengthening the board of a company?”*

Replies varied from the extremes of “rarely” to “almost always” and in one case “inevitably”, but every respondent within the group expected to have a role in strengthening the board at some time, once the need was identified. In the majority of such situations this was done through influencing the appointment of an additional non-executive who, in addition to having a very real input, would “monitor the management team in action” and whose appointment would “demonstrate proper due diligence.”

Investor/Institutional board representation

The subject of investor/institutional board representation achieved a high level of consensus with only one respondent replying “rarely” to **question three: *“How often do institutions insist on board representation?”*** The general rule of thumb was that a demand for representation depended on the level of investment and financial exposure and the perceived strength of the board, but occurred “more often than not.” A significant number of institutional investors stated that for them board level representation by a non-executive director was a prerequisite for investment, not least because they preferred to have “someone on the inside” who was “known to us and trusted”.

Dealing with a weak board

Question four posed: ***"how do they deal with a situation of poor board leadership in a company that remains sound?"*** Responses were unequivocally that investors and professional advisors would act to correct a situation where a board was displaying poor leadership or avoiding accountability and make it clear that the board structure must change. Invariably, when an institution has invested in a company, it will seek to influence change by diplomatic means or, should this fail, by exercising its financial strength and, if all else fails by publicly withdrawing financial and corporate support - these views were expressed in the strongest and frequently unprintable terms. For example, in paraphrase, "if they don't act in accordance with our recommendations they will never raise capital in the UK again."

The value of non-executive directors

Recognition by the group of the constructive role played by non-executive directors was also unanimously positive. **Question five was:** ***Do they shore up the board or play a constructive role?*** Responses included:

- ❖ "Good non-execs are very valuable: they can apply an overview that executives at the coal face are often incapable of."
- ❖ "In companies that we invest in they are invaluable, not least that they tend to hold a number of directorships and are not influenced by future prospects or the power of the chairman".
- ❖ "Non-execs provide great support in having a fresh outside view of the company moreover, they almost invariably bring particular skills, experience, and valuable new contacts."
- ❖ "They are a vital element in proper and effective corporate governance. For example, the remuneration committee should always be chaired by a non-exec."

When asked in question six ***how often they recommended non-execs?*** the consensus was that they encouraged the management team to find their own, but preferred to have an input to final selection. However, when invited they invariably made recommendations and, where they identified weaknesses they sought to apply pressure regarding non-exec appointments.

Answers to question seven ***do they keep a list of non-exec candidates?*** proved to be 100 per cent positive. Further, the view was expressed by some respondents that this was an essential element in their duty both to investors and the companies concerned.

Similarly, question eight ***do they ever look for outside assessment of board abilities i.e. due diligence on management as well as the company?*** received a 100 per cent positive reply, with supplementary comments including:

> "a detached and expert professional view of board structure has proved to be of significant value to us and our clients, whether it accords with ours or not. Of course, it can also serve to act as a buffer that takes us back from being seen to force change on the board, which causes bad feeling and often bloody mindedness."

The final question was ***how often do your gut instincts come into play when assessing a client?*** The responses were either "always" or "inevitably". But however sound the business plan, financial projections, company history and strength of the board appear on paper, if instinct caused a sense of unease the likelihood of investing or taking on a company as a client was massively reduced. "At this stage," one respondent observed, "I would rather be wrong for the right reasons than right for the wrong ones. If there are any doubts say no."

The Corporate Response

A spread of companies, all quoted on AIM, were invited to answer a series of related questions focused on identifying how they approached board structure. They were drawn from manufacturing, business services, financial services and hotels and leisure.

The first question sought to identify "who is the key decision maker for board appointments? and, overwhelmingly, the response was that such decisions were made by the full board. There were three companies, however, all within the hotels and leisure sector that unequivocally replied:

❖ "the Chairman".

The inquiry *"at what stage do you start considering an executive board appointment?"* engendered a broad consensus that this was a full board decision relating to identified needs for new skills and a change of balance as these occurred, with the added caveat from a minority that it also happened when an investor requested it as a funding requirement.

Question three was *"at what stage do you start considering non-executive board appointments?"* The majority responded that this occurred at regular board reviews when it was recognised that the board was "overstretched" and needed new skills, but a number of other factors were also identified, including:

- ❖ when an investor requires it
- ❖ when someone "presents themselves"
- ❖ when moving into new markets and need new experience and contacts
- ❖ when we are not achieving our KPI's on a regular basis

And, almost inevitably in one case:

- ❖ when the chairman requires it.

Answers to the next question: *"what are the key criteria for appointing a board director?"* provided few surprises, the consensus being summed up as: "relevant experience, track record, proven business acumen, specific skills." Additional answers included:

- ❖ proven leadership
- ❖ demonstration of good corporate governance
- ❖ does the Chairman like them?
- ❖ investor recommendation.

Respondents were asked if "one of the key factors affecting appointing directors from the "30 somethings" was their increasing requirement for a balanced work/family life? Almost all respondents stated that they had not experienced this situation and whilst the majority took the view that any director, whatever their age, must fulfil the required role even if it required working long and sometimes anti-social hours. However, one "30 something" company secretary of a financial services company responded:

- ❖ "I do think the trend will increase, and we are offering a flexible benefits package to make board membership more attractive for this group."

Whilst the CEO of a hotel and leisure company stated:

- ❖ "All our directors are in their 30s and I have not experienced this situation, but our industry is renowned for working long hours so it is expected."

A significant number of respondents added the caveat that their companies were not looking for "30 something" directors, and did not appoint them.

Corporate Governance is increasingly seen as a duty, not a choice.

Responses to the question *"what significant changes of expectation and attitude have you experienced among directors during the past two to three years?"* reported that that demand for equity and performance linked payments had increased overall. However, the greatest change identified by a major percentage of companies was the recognition by directors both executive and non-executive that corporate governance issues had become a major element in their board responsibilities. Indeed, one respondent stated, "whether or not we like it, we all identify corporate governance as a duty not a choice."

The recruitment process

When recruiting a director externally (both executive and non-executive) the question was posed: *"how long do you expect the search process to take?"* One reply was:

- ❖ "In an afternoon, because it will be someone we know"
- ❖ "Our policy is to only appoint executive directors from within"
- ❖ "It will be someone the Chairman knows."

In all other cases expectations were that such a process took on average not less than three months and sometimes spanned six months and beyond.

- ❖ "Finding people with true leadership ability and a willingness to accept accountability is not an easy matter, if taken seriously" observed one executive director."

The second question on this issue was *"what process is used in recruiting directors externally?"* The majority answered that they used a multi-faceted approach involving both specialist consultants and exploitation of their own contacts networks. Some 15 per cent, however, relied solely on specialist search consultants, whilst another 12-15 per cent relied solely on their own contacts, and a small minority specified the use of professional or trade associations.

Non-executive board appointments

A series of questions were asked regarding the number of non-execs on the board, their expected period of tenure, their value or otherwise, and if the company favoured appointing more non-execs in the future.

More than 50 per cent of companies had either two or three non-executives, whilst others ranged from one to five. In terms of their contribution to the company answers were predominantly positive, including:

- ❖ "significantly", "very much", and "they provide a valuable balance to the executives"

However a small percentage replied:

- ❖ "not much", not enough", and "not a lot".

All respondents expected non-execs to be on the board for not less than three years and a number responded "indefinitely". Despite the negative minority view of their contribution, 100 per cent were in favour of appointing non-execs in the future, particularly if they proved to be independent.

Expectations of non-executives' contributions to the board

One hundred percent of answers to the question *"when you made non-executive appointments what were your expectations?"* recognised that a good understanding of corporate governance was paramount. And, although a minority identified the need for specialist technical or operational skills, other factors had greater priority such as:

- ❖ adding credibility
- ❖ contributing to decision making
- ❖ providing a figurehead, particularly in the City, and
- ❖ contacts
- ❖ objective leadership

The final question was a broad one concerning board room performance: *"Over what time and against what criteria do you expect shareholders and private equity investors to judge the success of an AIM company board?"*

Over 90 per cent of replies identified share price and financial performance of the company as the key measure of board performance. However, views varied sharply on the question of time frame from:

- ❖ "every day", "every six months", and "very short term"

to:

- ❖ "annually", "over a number of years", and "over five years, with the criteria being the value of the business."

Shareholder power and board accountability, however, remained a mystery to one respondent who observed as a corollary to this question: "Who do the shareholders think they are? Do they think they own the business?"

Additional desk research

Desk research across approximately 500 AIM companies revealed a number of interesting facts:

- ❖ Less than 0.5% of AIM Board directors are women
- ❖ Over 90% of companies had less than 3 directors
- ❖ 80% of companies had 2 or more non-exec directors
- ❖ 74% of companies had a non-executive chairman
- ❖ 38% of companies were located in the South East of England
- ❖ 85% of companies joined AIM since 2000
- ❖ Only the manufacturing sector companies had 8 or more years trading
- ❖ 75% of companies had a website
- ❖ There were no HR Directors listed on the Companies reviewed
- ❖ 15% of companies showed a Sales or Marketing Director

End

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