

QUESTIONS AT AGMs - AN AIDE MEMOIRE

1. INTRODUCTION

The purpose of this 'aide-memoire' is, by focusing on typical shareholder issues, to stimulate thinking about what might be appropriate questions to ask at AGMs. Each section, therefore, touches on the background concerning each issue in order to suggest questions that might be asked.

First a bias must be admitted. We all have our favourite issue which some of us, it has to be said, can flog to death. Shareholder value is that issue for me. So my first question will always be - "Is the company creating (or destroying) value and if so how much value has been created over the relevant period?". The 'relevant' period will preferably be five years rather than, say, one.

2. SHAREHOLDER VALUE

2.1 Background

Research has shown that only some 50 percent of quoted companies create value, the rest destroy value. It seems to me incumbent on all shareholders to discover whether their company(ies) is a value creator or destroyer. This is not the place to indulge in a dissertation on how to measure shareholder value other than to say broadly a company creates value when its return on invested capital exceeds its cost of capital. I find that most chairman, when answering questions on this issue, merely equate share price movements to value creation. In other words, their thinking/understanding of the issue is pretty shallow. Merely to discover this shallowness by asking a well designed question can be very revealing - sometimes rather worrying!

One personal anecdote is perhaps relevant. Just before Trafalgar House was bought by Kaeverner, I posed the following question at their final AGM - "Your Board has destroyed, I estimate, some £1bn of shareholder value in the last two years, how many years will it take to destroy a further £1bn?". I wasn't surprised that the Chairman looked somewhat angry in answering this question. What did surprise me was that he immediately agreed with the figure of £1bn! So that taught me the lesson that, when designing a question on this issue, suggesting a figure that you yourself have estimated (it doesn't matter how crude it is) can achieve useful results, especially when the Chairman has no idea how to dispute, or even discuss, how the figure might have been arrived at. (PS It actually took only about one further year for the additional £1bn to be destroyed!).

2.2 Possible questions

A) "You say in your chairman's statement in the annual report that the company is focused on creating shareholder value (assuming he has done so!), will you tell us

please how much value has been created over the last five years (or one year) and how you have measured this?"

B) "I estimate that the company has destroyed value to the tune of £x millions over the last year. Do you agree with this estimate? If so, when will the company begin to create value for shareholders?"

3. CORPORATE GOVERNANCE

3.1 Background

We have experienced ten years (Cadbury reported in 1992) of vigorous debate in the UK on the issue of corporate governance - indeed a new growth industry was spawned and there have not been too many of those! The key question, I believe, we have to address is whether all the new codes and regulations have led to mere 'box-ticking' (viz Hampel Report) or to more value being created. I don't believe that question has yet even been properly addressed, let alone answered.

I suppose our primary source of ideas as to what questions might be appropriate for a particular company is the Combined Code which emerged from the many recommendations made by the various committees of enquiry which sat throughout the 1990s. In place of that approach I am going to quote from the recommendations made by two major institutions in the USA which are perhaps a little more succinct than the Combined Code:-

A) Calpers, the most active and influential US pension fund, has produced a 23 page set of core principles and guidelines concerning the governance of US companies. Calpers asserted that "accountable governance means the difference between wallowing for long (and perhaps) fatal periods in the depths of the performance cycle and responding quickly to correct the corporate course". The guidelines stress two particular requirements:-

- prompt disclosure and shareholder access to the Board via the AGM, and
- the production of long-term shareholder value should be the predominant factor.

B) The Council of Institutional Investors (CII), with some \$1 trillion of assets, produced in 1988 a so-called "Shareholder Bill of Rights" which can be summarised as follows:-

- Directors should be elected annually.
- At least two thirds of the company's board should be independent outsiders.
- Companies should encourage directors to acquire and maintain a meaningful stock position.

- Directors with full time jobs should not serve on more than two other boards.
- Equity based pay for directors and managers should be indexed to peer or market groups.
- All members of a board's audit, remuneration and nominating committees should be independent.
- A director is deemed independent if his or her only non-trivial professional, familial, or financial connection to the company or its CEO is his or her directorship.

3.2 Possible questions

Clearly a number of questions can be framed against the above brief guidelines depending on whether your company departs from any of them to a serious extent. It would be sensible to check also against the so-called Combined Code from which you can quote chapter and verse for any critical question which you put to the directors.

For example:-

- A) Why are not all the directors elected annually?
- B) Why are not at least two thirds of the directors non-executive?
- C) Why is the equity based pay for directors not indexed against peer group companies?
- D) Why are not all members of the nomination committee non-executive?

And so on and on and on.....

4. DIRECTORS' REMUNERATION - (OTHER THAN OPTION BASED)

A recent report indicated the scale of the enormous changes that have occurred in remuneration levels in the USA. For example, long-term incentive plans for CEOs have been increasing in value at the extraordinary rate of 30% a year. The typical US company now allocates 1.4% of its equity each year to executives and other employees, and in the new economy this dilution rate is more like 4%. In the UK, however, traditional companies grant only about 0.4% of equity each year in this way.

The key question to address is whether the remuneration is fair and reasonable in the light of the value created. Unfortunately this question is difficult to answer since information on whether value has been created or no is very rarely stated in the annual report. However, as always, why not adopt a simplified approach which can prove to be quite effective?

For example, look at the 5-year record, usually shown at the back of the annual report, and note the figures in each year for earnings and shareholders funds. Assume the cost of equity capital is 10 percent (it usually is about that figure) and note by how much the earnings in each year exceed (or fall short of) 10 percent of the shareholders funds. If the total figure for the five years is positive then that figure is your estimate of the value

created. If it's negative, then that is the value destroyed. The main point is to propose this figure to the board and then that puts the onus on them to agree or disagree and provide you with what they think is a correct figure and why. A constructive debate can then begin.

4.1 Possible questions

- A) I estimate that over the last five years £x million of value has been destroyed and yet the remuneration of the directors is twice (or whatever figure it is) what it was five years ago. Will you please explain how you justify this?
- B) I note from the Remuneration Report that the directors can gain extra remuneration from no less than six different so-called incentive schemes. You are in effect saying to shareholders that we can only expect our directors to give of their best provided they have no less than six different incentive schemes. Why is such a complicated system of reward necessary? How many really understand the interplay of all these schemes? Traditionally a donkey needed just one carrot to motivate it - our directors need six! (NB This question was promoted by my reading of the recent Rio Tinto Annual Report)

5. DIRECTORS REMUNERATION - OPTION BASED

This is a particularly complex and worrying area where the opportunities for abuse are at their maximum. First of all, it is helpful to try to understand what has been happening. The following points I have extracted from a recent article by the Economist:-

- The largest and speediest creation of fortunes the world has ever seen is taking place mainly because of lucky timing as directors happen to have been around when a greater slice of their remuneration has arrived in the form of share options.
- The spread of share options may be distorting the economy, contributing to a temporary over-valuation of equities, encouraging short-sighted managerial decisions and storing up problems for companies in the future.
- The top employees of big US companies now have a claim of more than 13 percent of the equity of their companies.
- Options that are not set off against corporate income inflate reported profits, perhaps by as much as 50 percent. If they were treated as an expense, recorded profit growth would be lower. In attempting to align the interests of the managers with the owners of a company, the owners have introduced a bias that may come back to bite them. Managers motivated by options have been jacking up their firm's prices, often by issuing debt and using the proceeds to buy back equity. Running up debts does make a difference to the value of those options.
- Shareholder have shown an astonishing willingness to share their equity with executives, and with remarkably few strings attached. The link between options and performance has usually been taken on trust.

- The average US chief executive now takes home 419 times the wage of the average factory worker. In 1980 that figure was 42 times.
- The fundamental question is whether share-option schemes are doing what they were designed to do: aligning the interests of managers with those of owners, motivating bosses to do their level best for shareholders.

5.1 Possible questions

- A) "What percentage of the total equity is on average granted in stock options each year?"
- C) "What is the approximate value in terms of percentage of equity of all outstanding options?"
- D) "What would be the approximate percentage reduction in profits if the executive share option schemes were charged against profits?"

6. DIVIDENDS

We must recognise that historically the attractive returns from owning shares comes from dividends. Recent research work by ABN Amro points out that £100 invested in the UK equity market would be worth some £1.6m today. But that number has relatively little to do with rising share prices and nearly everything to do with the re-investment of dividends. Without those dividends, the £100 in 1900 would have grown to be worth just £14,900 which would only have kept investors just ahead in real terms after taking account of inflation. Nor is it just over long periods that dividends count. For example, £100 invested in a free FTSE 100 index tracker ten years ago would be worth £199 without re-investment of dividends. With dividends reinvested, the £100 would be worth £278.

Thus the really attractive returns from investing in equities come from dividends. Despite this, I think it true to say that executive share option schemes are never (?) designed to reflect the company's dividend paying record. This suggests question A below.

A connected issue is, of course, how to judge what level of dividend payment is reasonable given the financial results of the company. Almost always, companies will use the earnings cover to decide this. Much more preferable in my view is to use the free cash flow (FCF) cover as the deciding factor. The reason is that the earnings figure is much more amenable to massaging than FCF. I have known one company which prided itself on maintaining a FCF cover of three times which would be very healthy. Usually I guess such cover would be 1.5 to 2 times. In these days, though, it's quite something to find companies which actually generate any FCF at all. (NB I would define FCF as - net cash flow from operations (the first figure in the annual report's cash flow table) less tax, interest and 'normal' capital expenditure.) This suggests a second question, B below.

6.1 Possible questions

- A) "You are no doubt aware that ultimately the company has no value unless it can create a sustainable dividend stream. You are also, I trust, aware of how much historically the value to shareholders of investing in equities depends on the reinvestment of dividends (quote some of the above figures?). In the light of these two facts, will you please tell me what the company's policy is on the payment of dividends?"
- B) "Does the company take any account of free cash flow cover when deciding what dividend to declare?" (NB. This may, of course, be covered by the chairman's answers to the first question.)

Donald Butcher, UK Shareholders Association, 2002