Governing for Growth

THE INVESTOR FORUM

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Contents

'Governing for Growth' is intended as a practical guide for smaller and mid-sized developing companies which are listed or have shares quoted on public markets. The objective is to support the process of growth and development of these companies as they grow their businesses and deliver long-term sustainable value.

S-360
Governing for Growth

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Governing for Growth

This Investor Forum S360 project identifies:

- indicators of the growing maturity of companies on public markets
- responses companies can take to enhance governance, generate and protect long-term sustainable value.

We provide practical observations based on investor experience gained through many years observing companies navigating a challenging phase in their development.

It is best to act ahead of matters becoming a significant concern - rebuilding trust after an issue becomes a problem is an expensive and time-consuming process

Overview

Many companies navigate their growth and development from small cap stocks to larger businesses smoothly. For others, this process of maturing is challenging. Too often, management is distracted from driving business success by problems that might have been avoided, had structures and governance been improved earlier. Investors can see a significant loss of value through such events, and often it takes time to recoup that value as the business only slowly finds a new, or renewed, rhythm.

Objective

This paper aims to identify a series of indicators that highlight when a company is reaching a stage in its maturity where it becomes important to build resilience and when greater governance structures may be advisable to help avoid such negative outcomes. It also seeks to identify a series of steps that might be taken in order to provide additional safeguards.

While this has been an issue over many years, it is notable that the current market environment has enabled a number of companies to reach significant valuations in a short time from founding and going public. The fact that this has occurred more rapidly than in the past increasingly means that greater value is put at risk for investors and company management at an earlier stage, and perhaps makes publication of this framework particularly timely.

Approach

Our approach recognises that every company is different and that needs will change over time: neither the list of indicators, nor the suggested responses, is intended as a mechanical set of steps. Rather, we have attempted to distil into practical observations the experiences of investors gained through many years observing companies navigating a challenging phase in their development.

Investors in smaller capitalisation companies that grow quickly experience these challenges across broad portfolios many times during their investment careers and so are able to recognise some of the most crucial challenges. In contrast, each company is unique and typically believes it can safely navigate the challenges of rapid growth.

Companies are dynamic, so this is not anticipated to be a one-off process, but a first stage in an iterative process where questions are asked on a regular basis with changes being made as and when they are perceived to be helpful.

It is best to act ahead of matters becoming a significant concern: rebuilding trust after an issue becomes a problem is often an expensive and time-consuming process, which both companies and their shareholders would welcome avoiding.

Context

This paper is published at a time when there is much speculation about the attractiveness of UK capital markets. The Hill UK Listings Review has raised fundamental questions about the current hierarchical structure (perhaps better described as the perceived hierarchy within that structure) of UK capital markets, including AIM, Standard and Premium Listings.

Even without the uncertainties about future structures produced by this Review, and in line with the Investor Forum's practical focus, the objective of this framework is agnostic about the form in which a company has come to market, the type of listing or the marketplace. A growing company with any form of traded shares can face the problems we identify and consider. Changing the nature of a company's listing is one of the suggested possible steps, but it is only one option and it is not intended to be seen as a universal panacea.

This work also takes place in the context of the BEIS consultation on *Restoring trust in audit and corporate governance*, which among other things is considering an extension to the current definition of a Public Interest Entity (PIE). Again, we look to be agnostic about the outcome of this consultation and merely note that this consultation provides some indicators of thresholds that might be seen as useful triggers to thought processes within the boardrooms of growing companies.

All companies benefit from asking whether their boards, governance structures and processes are suitable for the business as it now is, and its continually evolving business environment. It is this invaluable process of continual review and evolution – as well as the discipline to act on any conclusions reached – that the Investor Forum seeks to encourage.

Governing for Growth: indicators and responses

We set out below a framework which illustrates the key indicators of growing maturity and also the responses that companies might consider in order to enhance their governance in order to equip the organisation for further growth and success. In recognising the stages of maturity and taking proactive steps, companies can help bolster investor confidence that the growing value of the company can be sustained.

Each company is different, so we are clear that prescriptive rules are unlikely to be helpful. Further, there are no actions that can guarantee that failure, or even significant loss of value, will be avoided. But the indicators should spark questions and fresh thinking, and the responses can be used as helpful paths forward. Our approach seeks to encourage companies and their stakeholders to take practical steps that give the best chance of helping sustain business momentum and maintain value throughout the growth phase.

The indicators of growing maturity are set out in three categories: **Operational**, **Scale** and **External perspectives**. Under each heading, there are three aspects of a company's development, or the views of key partners, that may suggest a need for change.

Similarly, the responses to enhance governance are set grouped into three areas of focus: **Position**, **People** and **Processes**. Under each, there are a number of different steps that a company might consider taking as ways of enhancing its governance processes and structures so as to address the issues that begin to arise.

This framework has been developed based on a series of roundtable discussions and with the assistance of a panel of experienced practitioners[1].

[1] See page 11 for Panel of practitioners.

Indicators of growing maturity

Scale

Shareholder register: Change in shareholder register as larger cap investors join small cap specialists and retail investors

Size: Crossing of thresholds on number of employees, turnover or balance sheet (such as those e.g. for the Wates Principles or the PIE proposals)

Market cap: Market capitalisation increases beyond a threshold of say £1bn

Operational

Management style: Management based on personal relationships has shifted to management processes

Line of sight: Central management team no longer has clear line of sight to all operations

Business complexity: Range of business challenges expands (e.g. entering new geographies or business segments, internalising formerly outsourced functions, facing fresh legal/regulatory questions)

External perspectives

Shareholder: Change in the nature of the expectations from institutional investors

Stakeholder: Pressure from other stakeholder(s) builds

Adviser: Nomad or broker recommends change

Responses to enhance governance

Position

Shareholder: Regularly seek an understanding of expectations of leading institutional shareholders

Board evaluation: Deliver formal board evaluation process, and respond appropriately

People

Executive: Appoint executive director with larger UK public company experience

Company Secretary: Appoint company secretary (with UK public company experience)

Senior Independent Director: Appoint a SID with larger UK public company experience

Experience: Encourage executive team to seek NED roles on other boards, or coaching

Chair: Appoint an independent chair

Processes

External audit: Put audit out to tender

Related Party Transactions: constrain activity and offer independent shareholder vote

Internal audit: Develop internal audit function

Pay schemes: Seek approval for new remuneration schemes

Annual pay vote: Offer annual vote on remuneration

Listing: Consider changing form of listing

Indicators of growing maturity

These indicators are not intended as a one-off triggers or thresholds. Rather, each aims to help spur a renewed conversation on the governance of the company. Any conversation on the need to evolve governance as the company grows ought to be an ongoing one, with incremental changes being made over time. Steady incremental change will bring least disruption, while limiting the risk of change coming too late to avoid significant issues arising.

Our hope is that the list of indicators will help spark conversations within companies, between companies and their advisers and between companies and investors: where an indicator is passed without recent changes having been made, it may suggest that further evolution is needed.

The mere fact that one indicator has not been reached, such as for example that investors and advisers are silent and have not advocated change, should not necessarily be taken as a reason for inaction. Similarly, being below one or more of the numerical thresholds referenced should not be deployed as an argument that no change is needed.

Operational

<u>Management Style:</u> Management based on personal relationships has shifted to management processes

- Smaller businesses can operate largely based on the personalities and energy of a small number of key executives. The need for process and structure is limited because of the understanding that develops between these individuals, and their personal drive, and the fact that they can communicate these directly and personally to the broader team.
- Over time, it becomes harder to rely simply on such personal relationships. The organisation and ambition of a successful organisation must outgrow this approach, and process and structure need to be added.
- As such processes and structures develop, the need for governance oversight also grows.

<u>Line of Sight:</u> Central management team no longer has clear line of sight to all operations

- Early in a business's life management may have been directly aware of all activities, visited all operations regularly and will likely have close relationships with all key employees.
- This becomes less possible as the business grows and the number and scale of operations also expand. While management may still feel it has clear oversight and control of all activity, the nature of that oversight must evolve as the business grows.
- Such developments can be a sign that additional structures and processes are needed.

<u>Business complexity:</u> Range of business challenges expands (e.g. entering new geographies or business segments, internalising formerly outsourced functions, facing fresh legal/regulatory questions)

- In part, this is just a question of scale and so it may be a reflection of it being harder for management to have line of sight. But more than that, this indicator tries to capture changes in the nature of the management challenge, not just in its scale:
    - operations in new geographies and in new segments may feel like natural evolutions for a business, but they often bring additional management and oversight issues that may not be apparent in advance;
    - similarly, insourcing functions within a growing business can be the economically right decision once an appropriate scale is reached, but may deliver a different nature of issues for management discussion and oversight; and
    - legal and regulatory challenges may need management to access new advice or just to hear new voices regularly within the boardroom.
- Other developments within the business may have similar implications.

Scale

<u>Shareholder register:</u> Change in register as larger cap investors join small cap specialists and retail investors

- A change in the nature of the investors that are interested in participating in and supporting a company's future success may lead to a different nature of dialogue with shareholders and different expectations.
- When a company is included in large cap portfolios of leading institutions, it can be a sign that the business has reached a stage of maturity and development, such that the expectations of its prior shareholder base may also have shifted.
- Ideally, the company would not wait for changes in its shareholder base before evolving its governance; indications of interest from larger cap investors might prove a useful trigger, and their investment may on occasions depend on seeing an evolution in governance.

<u>Size:</u> Crossing of thresholds on number of employees, turnover or balance sheet (such as those e.g. for the Wates Principles or the PIE proposals)

- The Wates Principles apply to companies with more than 2,000 employees, or with a turnover of more than £200m, and a balance sheet of more than £2bn. The government is currently consulting on extending the definition of Public Interest Entity to include companies either based on these same criteria, or those with over 500 employees, and a turnover of more than £500m.
- Our aim is not to choose between these criteria. Rather, our view is that there is no one threshold that marks a change. This should be seen as a form of sliding scale – as the company grows, expectations for greater evolution of its governance will also develop.
- It may be worthwhile therefore for the board to consider reviewing the company's structures and approach as it passes significant turnover thresholds, such as £200m, £500m or £1bn; and/or 500, 1,000 or 2,000 employees. Many investors will expect most best practices to be in place by the time these latter thresholds are passed.

<u>Market cap:</u> Market capitalisation increases beyond a threshold of say £1bn

- Again, this is not intended as a precise threshold. If a volatile share price happens temporarily to bring the market capitalisation above £1bn for a short period of time that may not be as significant as if the valuation is consistently over £900m for an extended period of time. This scale of value at risk, and the greater attention, both from investors and others, that it brings, may of itself mean that additional protections might be warranted.
- Given different levels of gearing among companies, the equity market capitalisation might not be the only useful indicator. It may make sense to consider the enterprise value of the business, particularly a highly geared one, aggregating debt with equity capitalisation rather than simply focusing on the equity.

External perspectives

<u>Shareholder:</u> Change in the nature of the expectations from institutional investors

- Companies are well-advised to listen to the views of their shareholders, and should indeed seek them out even when they are not forthcoming. It is better to be ahead of concerns rather than rectifying matters only after a problem has arisen.
- An active programme of soliciting investor views, including using independent channels such as the non-executive directors, can help shape companies' approach. Such a regular programme should help in identifying changes in tone or expectations.
- As size increases, giving formal responsibility for investor relations to a designated individual, rather than solely to a founder, is an important consideration.

<u>Stakeholder:</u> Pressure from other stakeholder(s) builds

- Companies need to be conscious of stakeholder views, particularly if the same issue arises from multiple members of one stakeholder group – and still more so, if from more than one sort of stakeholder.
- Over time, boards may seek to ensure that they are kept informed of the tone of relationships with the key stakeholder groups (employees, customers, suppliers), to help in running and overseeing the business as well as assisting directors in delivering their duties under s172 of the Companies Act 2006.

<u>Adviser:</u> Nomad or broker recommends change

- Advisers, like shareholders, have experience of multiple companies going through the process of growth and development. That experience, and the advice that comes from it, may be valuable in navigating the challenges faced.
- Other professionals, such as lawyers and auditors, may also be able to spot early warning signs and so provide advice and input.

Responses to enhance governance

The steps identified should be considered as part of the evolution of a company's governance as it grows. They are not written in any order of priority, and are not intended to build one on another.

Some may arise naturally as part of the maturity process (such as seeking to appoint an executive director with PLC experience, arising when a new appointee is sought); others will deserve ongoing consideration.

Some investors have indicated that a regular board evaluation process, if done properly, should bring to the surface any developing needs for evolutions in governance. Disclosure of the existence of an evaluation, what its key conclusions were and how those are being addressed over time would therefore be strongly welcomed.

Position

Shareholder: Regularly seek an understanding of expectations of leading institutional shareholders

- As signs of maturity emerge, companies should reflect on any changes in the views of their shareholders, and seek out views, even when they are not forthcoming.
- Institutional investors will generally believe that governance issues should be discussed with non-executive directors, and preferably independent non-executives, so such directors should expect to make some time available for discussions.

Board evaluation: Deliver formal board evaluation process, and respond appropriately

- Board evaluations will be most effective and give most confidence when carried out by a reputable external party. Nevertheless, provided board members are honest in their views and about the needs of the business – and those views are accurately captured and acted on – an internal process can also deliver effective change.
- A board evaluation should bring to the surface any skills that might be lacking around the board table. Investors will expect to see individuals among the non-executive directors with skills and experience in the company's operating sector, and also non-executive directors with appropriate finance and/or accounting expertise. Investors see both independence and diversity as crucial indicators of quality in boardroom debate.
- Providing investors with clarity as to the high-level outcomes of the board evaluation, and what is being delivered as a result (and over what timeline) will give rise to greater trust.

People

<u>Executive:</u> Appoint executive director with larger UK public company experience

- This is not advocating that the existing management team needs to change.
- However, should the company need to appoint a new finance director, or the board believe there would be real value in bolstering the management team with a COO or head of a developing region or business line, then including large PLC experience as one of the criteria sought from that individual is likely to prove valuable.

<u>Company secretary:</u> Appoint company secretary (with UK public company experience)

- A quality independent company secretary can add real value to the functioning of a board and the effectiveness of its discussions and decision-making. Smaller companies often ask an individual (particularly the finance director) to cover this role alongside their other responsibilities. This becomes more challenging and less appropriate as the organisation grows.
- Addressing this issue, and assigning responsibility to a designated individual, will also assist in delivering many of the other changes identified among the potential steps.

<u>Senior Independent Director:</u> Appoint a senior independent director (SID) with larger UK public company experience

- Bolstering the independence within the boardroom, particularly among the more senior non-executive directors (SID and/or chairs of the audit and remuneration committees) needs to be a standard part of what should be an ongoing process of board renewal and refreshment. Ensuring that these key individuals can bring knowledge and experience from larger public companies will assist with the breadth of advice and insight that they can bring to the growing company.
- Over time as the company grows and matures, many institutional investors will expect that the proportion of fully independent non-executive directors on the board will approach the 50% level expected under the UK Corporate Governance Code. Diversity in the boardroom is also a key issue.

<u>Experience:</u> Encourage executive team to seek NED roles on other boards, coaching or other forms of development

- It can add significant insight and value for executives to see the functioning of other boards and gain perspectives of different systems and structures.
- If it is felt that the executive cannot be spared for long enough to take a non-executive position, some of the same value can be gained through coaching or other development programmes.

<u>Chair:</u> Appoint an independent chair

- The position of chair is often held in growing businesses by an executive or by an individual who has been closely involved in the company's development. Making a change by appointing an independent chair can be a key move to reflect the maturity of the business.
- This new chair should bring skills and knowledge of the industry as well as an independent perspective and PLC experience.

Processes

<u>External audit:</u> Put audit out to tender

- This paper does not argue that all major public companies should be audited by a particular scale or sort of audit firm; we welcome increasing numbers of audit firms competing for public company business.
- Nevertheless, as a company grows it may begin to outgrow some of its earlier advisers, and so testing the market in a tender process and seeking a change may be appropriate.
- Increasingly, a number of investors are seeking to enforce with their votes the 20-year maximum auditor tenure standard whether or not it strictly applies to a company.

<u>Related Party Transactions:</u> Constrain activity and offer independent shareholder vote

- While companies subject to certain regulatory regimes may be free to pursue certain related party transactions with limited independent oversight, investors will become increasingly concerned about these, especially if their absolute financial value is significant.
- Thus, even where approval may not be required, companies should give consideration to providing full disclosure and putting such transactions to independent shareholders for their approval (i.e. with those individuals or organisations connected to the related party not voting on the relevant resolution).

<u>Internal audit:</u> Develop internal audit function

- Often seen as the preserve only of larger companies, internal audit can be a vital tool for giving both management and the board the confidence that what they expect to be in place is in fact being delivered on the ground – so it should be given active consideration even by smaller companies.
- Any function should be scaled appropriately, and may only involve one/two individuals at small companies.

Remuneration can be a significant source of friction and as such we have identified two aspects which merit attention to better align expectations – approval of new pay schemes and annual pay votes:

<u>Pay schemes:</u> Seek approval for new remuneration schemes

- Even if a company's regulatory regime does not require it, greater investor confidence can be created by taking a new remuneration scheme to shareholders for voting approval at a General Meeting, and perhaps for detailed consultation beforehand. Sufficient detail should be provided to enable shareholders to reach reasoned conclusions about the value of the scheme for the company's success.
- Not seeking prior approval may make awards an annual issue between the company and its shareholders.

<u>Annual pay vote:</u> Offer annual vote on remuneration

- While only required of companies under some regulatory regimes, investors increasingly expect any company of a given scale to offer an opportunity to endorse remuneration decisions over the prior year.
- Such an advisory vote can be a useful way to understand concerns and perhaps defuse tensions. The discipline of transparently explaining remuneration committee decision-making over the year can be valuable in itself. Companies should provide sufficient insight into the details of remuneration structures (and specifics such as shareholding requirements) to enable shareholders to be confident that the approach to remuneration will help promote the success of the company.

<u>Listing:</u> Consider changing form of listing

- One mark of maturity of a business may be to change the nature of its listing and so to voluntarily adopt a heightened series of regulatory expectations (some of which have been noted above as individual steps).
- Such a step may make the company more visible – and, in some cases, investable – for a wider range of institutional investors.

Panel

We are grateful to the following individuals who formed a Panel assisting the Investor Forum in developing this document. Their employer is mentioned for information only; participants acted in a personal capacity. Any, and all, errors remain attributable to the Investor Forum.

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