2019 Season Forecast

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2018 – It's Spring Again?

Remember the "Shareholder Spring"? A movement whose roots date back to the fall-out from the Financial Crisis gained further momentum in 2018. Aside from the now usual focus on executive remuneration, shareholders of all stripes sought to broaden their examination of corporate structures. Gender diversity on boards, the independence of non-executive directors (NEDs) and the time commitments of key NEDs all came under the microscope.

With a plethora of new Codes and guidelines being released in late 2018:

- The Quoted Companies Alliance update to help AIM companies meet their new Rule 26 reporting requirements
- The updated Investment Association's Principle of Remuneration; and the 25th anniversary edition of the UK Corporate Governance Code

There will be a lot of investors giving their own voting policies a Spring clean. Invariably this means a toughening up on the reporting and governance expectations of the companies they own.

Add to this the implementation of the second Markets in Financial Instruments Directive (MiFID II), the last 12 months has seen considerable change within the UK equity capital market. Institutional investors (the "buy-side") are to pay separately for both investment research and company meetings previously provided as a "bundle" by the investment banks. With research increasingly scarce and bank-sponsored corporate meetings reducing, there has been an emphasis by investors on their own corporate engagement teams.

Boudicca's own research, conducted at the end of 2018, revealed a larger internal role for engagement teams at institutions. Often, they were conducting out-of-calendar programs, meeting key NEDs to understand how their advice to executive teams was driving shareholder value. We found that engagement specialists are now very much part of the ongoing stewardship role of the investment manager, providing insight and advice on a wide range of issues.

Our conclusion, the basis for our 2019 Season Forecast, is that the "Shareholder Spring" will continue and, indeed, accelerate. Critically, it is not just a Season, it now appears to be a year-round feature.

2019 Season Forecast – Einstein's Definition of Madness

Like any long-term relationship, shareholders and the boards of the companies they own will not see eye-to-eye always. This was certainly true during 2018, but we sense that the gap between what investors want and what boards are prepared to do is narrowing, and at a faster pace than ever. To an extent, this relates to the high-profile nature of certain issues last year, but it also reflects the work conducted by buy-side engagement teams in raising their own profile within UK board rooms.

While we cannot discount further, public disagreements over pay and related issues, our central forecast for 2019 is that non-public, consistent engagement between shareholders and boards is already well advanced. This should result in more issues being resolved before a General Meeting than has been the case in recent years.

This is not to suggest a sanguine approach by boards. Rather, we would emphasise the need to understand the role played by engagement teams within shareholder bases and, critically, that played within funds who do not yet own shares. Meet them half way and the relationship will be more supportive. Relying on a late burst of meetings ahead of an AGM is less efficient and could risk adverse publicity.

Environmental Social and Governance Issues (ESG)

This will continue to have an increasing amount of time under the spotlight as it develops further from niche to norm; although the stand-out issues are likely to remain Remuneration and Sustainability-related. Boards will be expected to improve their reporting of these issues and how all stakeholders of the company are affected as per Section172 of the Companies Act.

Boards will also likely see BlackRock, Vanguard, and other passive fund giants continue their shift toward more active oversight of their shares, voicing concerns on issues such as environmental impact, workers' rights and supply chain management.

The continued progress in consolidating UK Local Authority Pension Funds (LAPFs), which will see 89 individual funds merge into just 8, is likely to see further emphasis on ESG issues from a constituency which speaks for over £200bn of assets under management. These funds, many of which are managed externally, are likely to require the successful manager to maintain a rigorous set of ESG policies which could migrate to other accounts under the same managers.

Investment using environmental, social and governance factors has been taking a more important role each year and it is likely to continue. European rules on fund managers considering sustainability and greater scope for fiduciaries to consider ESG issues in their investment process will increase the likelihood of E&S issues being a core part of engagement by fund management firms and the companies in which they invest. Most investors are also aware of increasing client interest in ESG. It is therefore likely that E&S will increasingly, if slowly, translate into an issue at AGMs.

Warming Climate

It will gradually get hotter at AGMs on the subject of climate change.

We can expect that there may be further shareholder requisitioned resolutions on the subject of climate: Royal Dutch Shell saw a resolution proposed last year. However, the UK remains unlikely to see the same level of activism at AGMs on climate and other ESG issues as at US companies but there is a prospect of a gradual increase in such activism in the UK.

In 2018, Legal & General Investment Management received coverage highlighting a more focused approach. Some of LGIM's active funds were selling interests in companies over responses to climate change but LGIM, including for the large index-tracking funds, were voting against the chairs of companies which do not provided adequate adaptation to a changing climate. Other large index managers were also taking a higher profile on climate although it is to be determined whether that is translating to votes against boards on climate-related resolutions. They are certainly engaging with boards on climate and emissions but the extent to which that might be reflected in voting remains uncertain.

A key point to make is that, even where there is no climate-specific resolution, other resolutions might be used by shareholders to convey messages regarding the policy or practice of a company on climate issues.

It remains, as for all subjects, the case that good communication of clear, progressive policies on anticipating and positively adapting to changes in circumstances - on climate, the circumstances including environmental and societal impacts and government measures - will be a core part of business activity and an important part of engagement with shareholders. Adequate reporting on climate risk and implications is a necessity. It goes without saying

Engagement methods: mass civil disobedience

This might not be a method of engagement between shareholders and companies, but it may still affect AGMs. Activist groups and NGOs may turn up and seek to protest at, or to otherwise disrupt, AGMs. A group which has appeared recently is Extinction Rebellion with, for example, blockages of roads in London as part of a mass civil disobedience campaign on climate change. Do not be surprised if these protests turned up at company AGMs, particularly for companies which are involved in industries linked to high CO_2 emissions.

Shareholder Engagement

If a December year-end company's board has not actively engaged with its shareholders on key governance issues by now (January 2019), it may be too late already. However, as we highlighted earlier, the increased importance of engagement within the buy-side may allow boards to get a better understanding of these teams' requirements through the financial calendar. We predict that the larger engagement teams may be listening on results calls and could be looking to meet at the same time as executives meet managers and analysts. It is important to note that many of the larger institutions are now asking for meetings themselves under MiFID II, but boards should not wait to be asked. A proactive and timely approach is required with an audience that remains under-resourced. It will be appreciated.

Remuneration / Pensions

Total remuneration will remain a focus for 2019 as shareholders examine not just salaries but LTIPs and, increasingly, pensions as a result of the amended version of the Investment Association's Principles getting tougher on what is seen as the 'norm'. The "Persimmon Effect" looms large for many of the buy-side. Remuneration Reports will be read thoroughly, and detailed questions will be asked. This may result in more commentary from the investment analysts (the "sell-side") where shareholder concerns over non-operational issues, such as remuneration, leak into the equity value discussion. Non-executive directors will play a significant role in this wider discussion and boards should consider making key personnel (e.g. Head of RemCom) available for investor meetings at an early stage in the reporting process.

Diversity – with Broader Skills

Shareholders are likely to widen their views on the diversity they wish to see on their companies' boards. There will be more focus on examining the skillset of the board, especially in relation to matters such as marketplace knowledge and cyber security; rather than focusing just on the diversity of the members themselves. Over the last year, we have seen several major cyber and data breaches at some of the largest public companies, so this is already an area of investor focus. Boards will have to identify who in which committee owns that risk management responsibility, and how that risk is managed.

Detailed succession planning is also likely to be a focus for 2019. Boudicca believes that, alongside the examination of a board member's relevance to the company, shareholders will look to assess their likely path (or not) to the top job.

Auditor Issues

The current focus on the predominance of a small group of audit providers is likely to raise questions during 2019. Boards will be asked as to whether there are any concerns around the effectiveness of the auditors and if the lead audit partner has been linked with any significant auditing controversy. Precisely what other audit-related services factors (in addition to non-audit services and fees) should be considered in evaluating the independence of the external auditors (e.g., tenure of firm/partner, regulatory fines). The quality of audits themselves will come into question, and investors will look into voting against auditors where the audit partner has been associated with audit quality concerns at other companies. There will be increased engagement with Audit Committees on how they ensure the quality of the work the external auditors undertake.

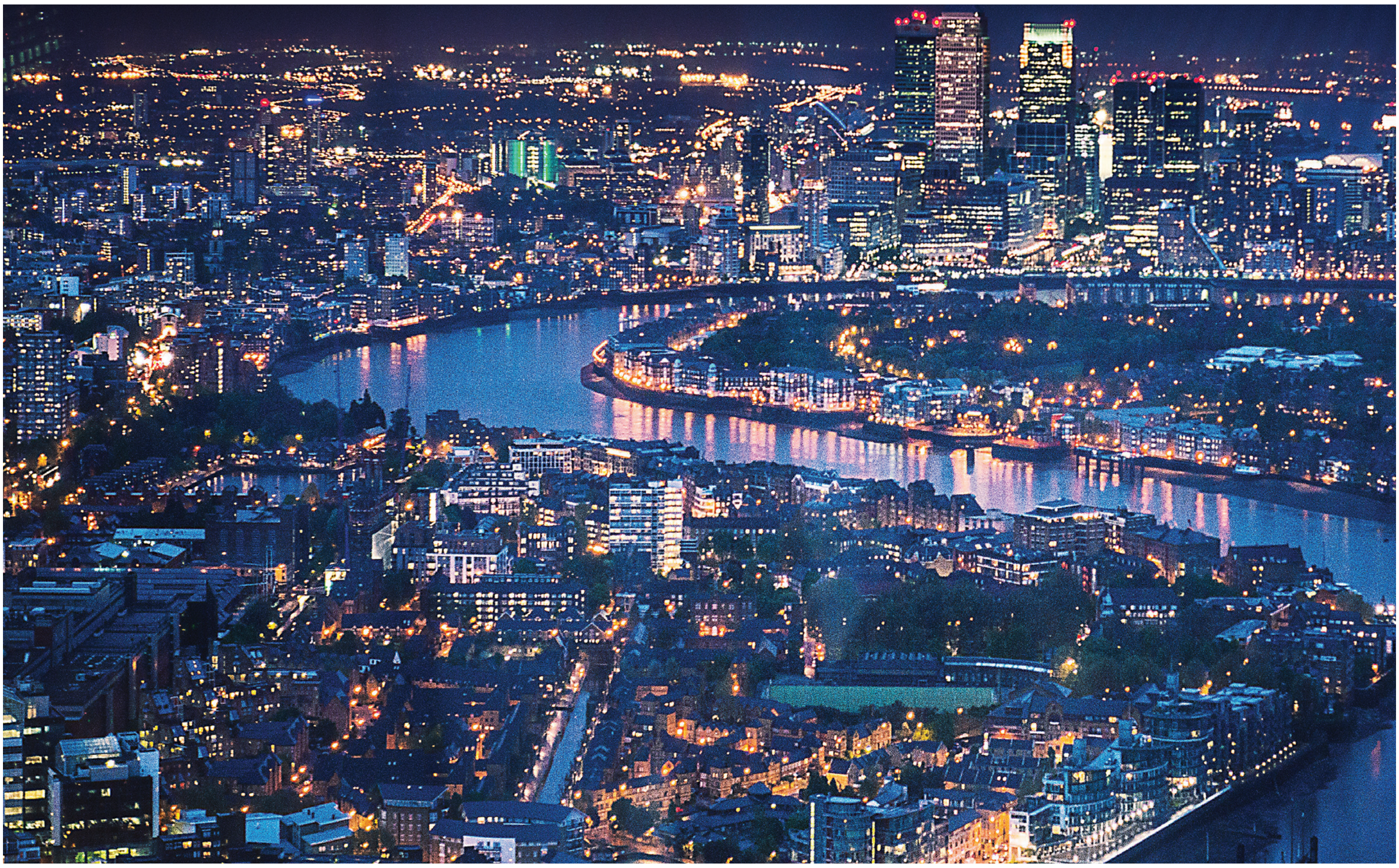
Audit Committee members will also be examined for links to audit concerns raised at other companies where they are Committee Chairs or members.

Employee Representatives

Not withstanding Brexit, the potential for political change in the UK is a significant factor in any assessment of corporate governance in 2019. Should we see either a "People's Vote" or another General Election, the "pay gap" in the UK is likely to be a feature. Within this debate, the prospect of greater representation at board level for employees is likely to be resurrected. On the grounds that reconnaissance is never wasted, we believe that boards should examine their own positions on this point and be prepared to answer questions from shareholders throughout the year.

Board Accountability

The "public face" of the board is no longer just the Chair and key executives. Shareholders will look to hold specific committee Chairs to account on issues. The Heads of each of the Audit, Remuneration and Nomination Committees may be targeted respectively owing to such dangers highlighted by: audit situations at Carillion and Patisserie Valerie; internal pay ratios and pensions; inadequate diversity and tenure of Chairmen. They are likely to have a busy 2019 – not just at the AGM but throughout the year.



This report was written by Boudicca Proxy Limited ("Boudicca")

Boudicca is part of the Equiniti group of companies and is a specialist shareholder engagement company.

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