2016 ISS Study on Controlled Companies

Institutional Shareholder Services, Inc., [excerpt, pp. 4-14]
March 2016

Controlled Companies
in the Standard & Poor's 1500

A Follow-up Review of Performance & Risk

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March 2016

Executive Summary

All controlled companies are not created equal. At some companies, founders and their families, or other large investors simply own large blocks of their companies' sole class of voting stock. At these firms, voting power remains directly proportionate to the investor's at-risk capital. More often, controlling shareholders use multi-class capital structures to concentrate voting power without commensurate capital commitments or risk of loss. Supporters of these multi-class structures argue that control of a firm's voting power enables management teams to minimize the impact of short-term market pressure, so as to focus on long-term business prospects. They promise higher returns over time in exchange for public shareholders' loss of control.

Should questionable practices arise at controlled companies, the two main protections available to shareholders are caveat emptor and the so-called Wall Street Rule—sell your shares if you do not like the way the company is managed. Unlike many global markets, the U.S. — at the state, stock market and federal levels—provides limited protection to minority shareholders. The major U.S. stock exchanges, for example, relax their basic governance listing requirements for "controlled companies." As a result, governance provisions which provide safeguards for external shareholders, such as a majority of independent directors on their boards or independent nominating panels do not apply to controlled companies. At least partially as a result of this reduced level of accountability to external company shareholders, controlled companies attract disproportionate attention when questionable practices arise.

Some controlled companies function as benevolent dictatorships. The controlling investors' high degree of alignment with other shareholders drives value creation, while control allows for innovation and speedy decision-making. Some regard Berkshire Hathaway through this lens. Boards at a number of these firms comply with their listing stock market's independence rules despite legally being exempt from these requirements.

At other controlled firms, however, the adage about the corrupting qualities of absolute power rings true. At these companies, self-dealing, poor strategic planning, and other risky behaviors destroy value.

While it is convenient to assign white or black hats to controlled companies, such a view is overly simplistic. In practice, controlled companies generally exhibit both the same types of behaviors—good and bad—as other public firms. When poor practices arise at controlled companies, however, basic oversight mechanisms (such as proxy contests and unsolicited offers) often prove ineffective and meaningful changes in corporate culture are difficult to achieve. As a result, the media narrative for these controlled firms lurches back-and-forth between behavioral extremes like a corporate version of the fictional Dr. Jekyll and Mr. Hyde.

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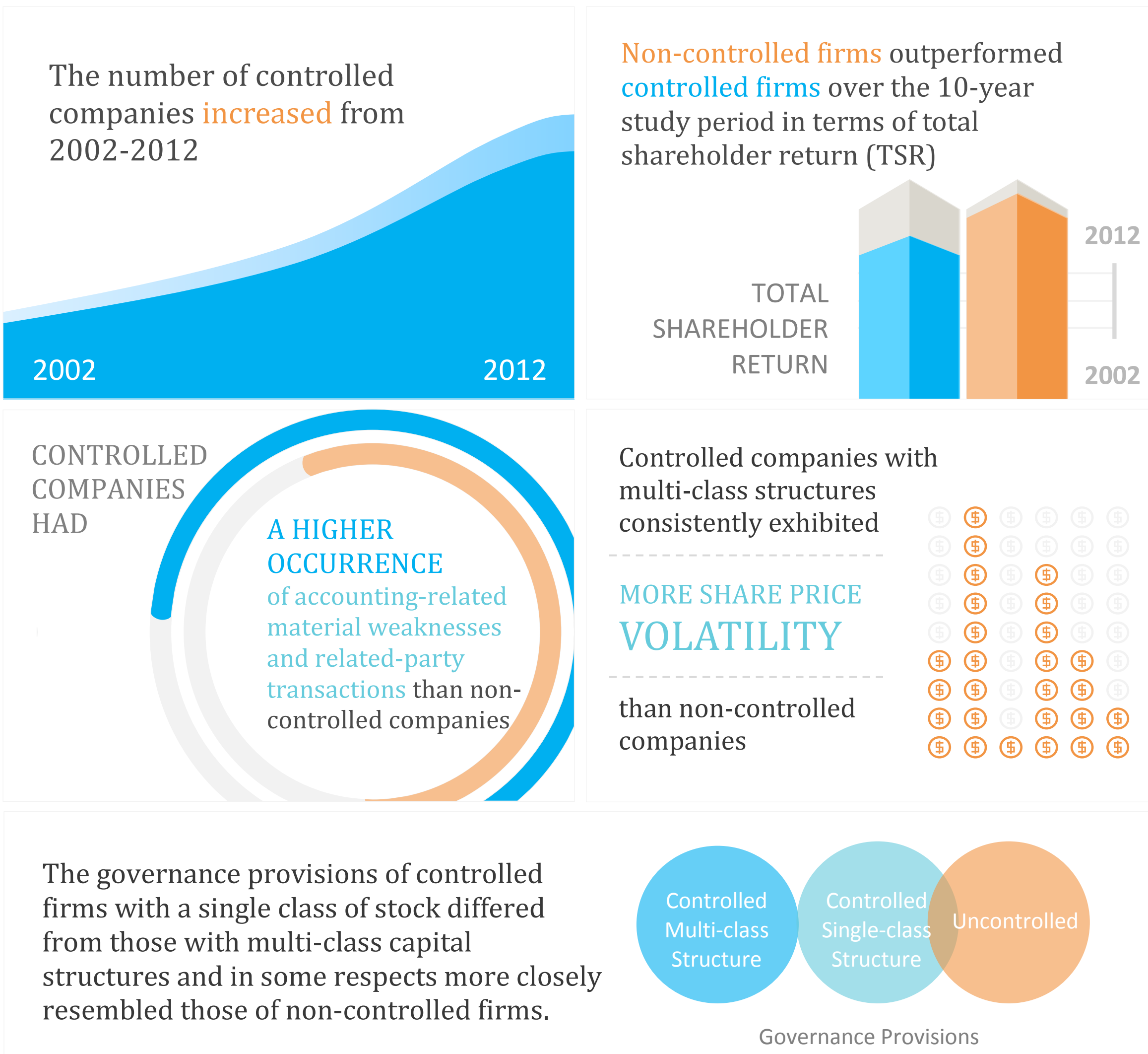
The issue of corporate control structures received renewed attention in the wake of the initial public offering of Google (now renamed Alphabet) in 2004. Citing Berkshire Hathaway as their role model, Google's founding duo issued a "founder's" letter, an owner's manual of sorts for shareholders, modelled after Warren Buffett's letter to Berkshire's investors, which justified a controlling dual-class stock structure.

A corporate conga line of social media and internet concerns—including LinkedIn Corp., Zynga Inc., Groupon Inc., and Facebook Inc.—soon followed in lockstep.

In response to this wave of multi-class stock issuances, ISS conducted an analysis of Controlled Companies for the IRRC Institute (IRRCi) in 2012. This predecessor report focused on the long-term performance and risk profiles of controlled companies in the S&P 1500 universe.

Key findings of the original 2012 study included:



The issue of dual-class controlled corporations continues to be topical. Alibaba made global headlines in the fall of 2013 when it shopped for a stock market that would allow it to adopt a controlled company structure. Hong Kong refused to lift its restrictions on dual-class capital structures, so company founder Jack Ma opted to list on the New York Stock Exchange (NYSE), which had long ago declined to support a mandatory one-share, one-vote standard. T. Rowe Price, a prominent investment manager with over $700 billion in assets under management, recently signaled plans to vote against board chairs (or lead independent directors) and members of the Nominating and Governance Committees at U.S. firms controlled by way of multi-class stock with unequal voting rights following concerns around the proliferation of IPOs with dual-class capital structures. A recent study by law firm Morrison Foerster of 580 "emerging growth companies" that had their IPOs between Jan. 1, 2013 and Dec. 31, 2015 found that 99 (17 percent) qualified as "controlled" and 87 (15 percent) had multiple classes of stock at the time of their public offerings. ISS' examination of recent IPO activity found that IPOs of companies with multiple classes of voting stock has increased in absolute numbers but declined in percentage terms over the study period and that the size of these offerings has soared and, as such, investors' market exposure to their potential risks appears to be rising.

This new report and expands the scope of the original study (2012) to include additional comparative dimensions around controlled companies in the S&P 1500 index.

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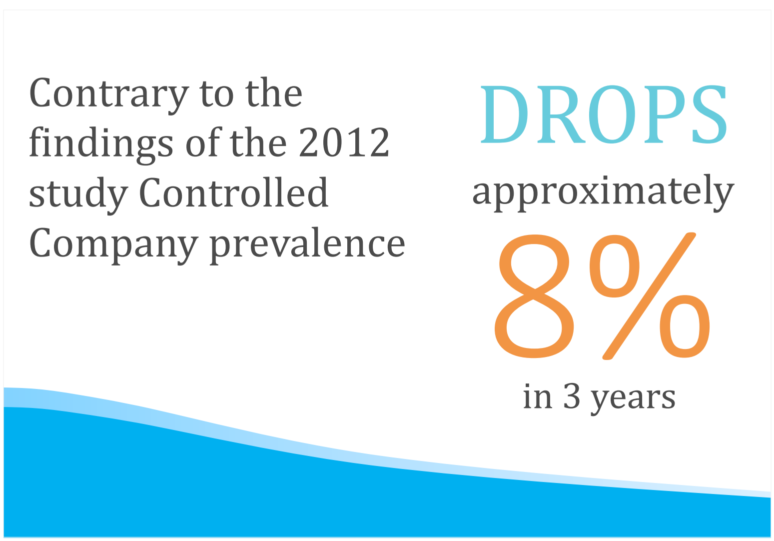
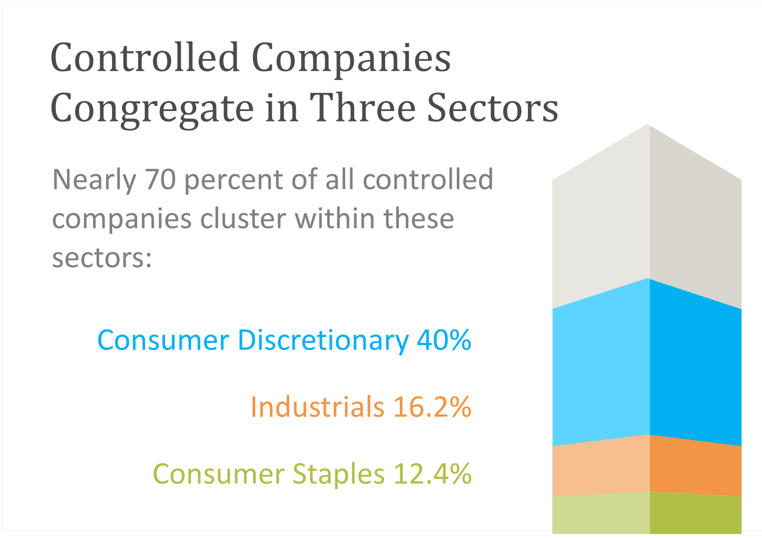


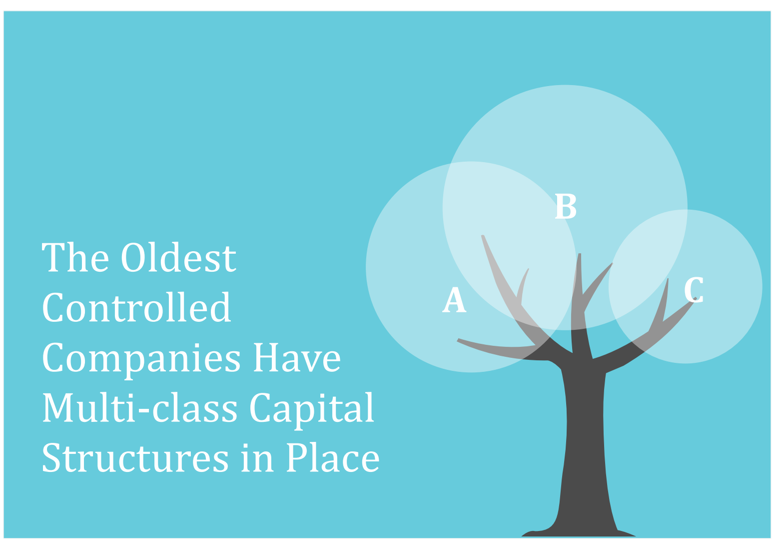
Controlled Company Prevalence Drops

Contrary to the findings of the 2012 study, the number of controlled firms in the S&P 1500 fell by approximately 8 percent from 2012 to 2015.



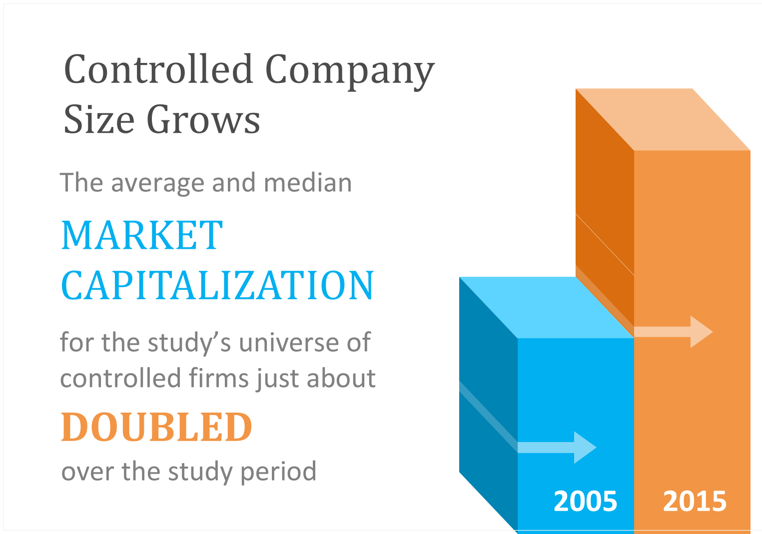
Controlled Companies Congregate in Three Sectors

Nearly 70 percent of all controlled companies cluster in three sectors: Consumer Discretionary (40 percent), Industrials (16.2 percent) and Consumer Staples (12.4 percent).



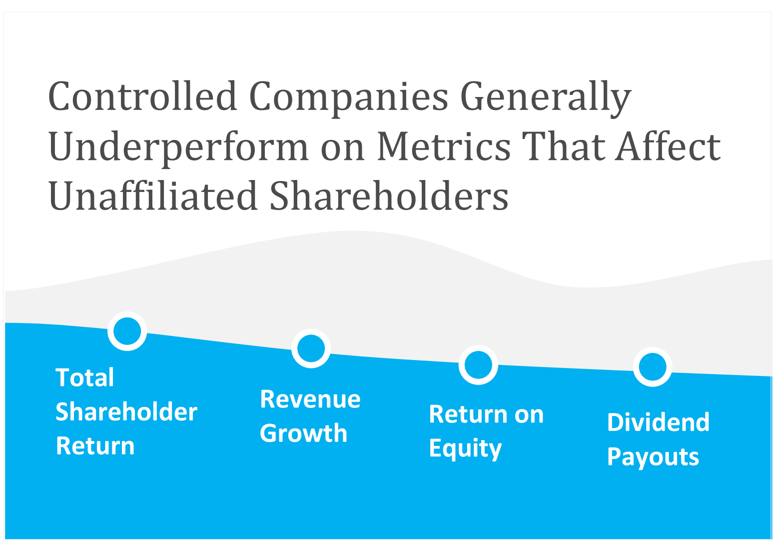
Control Type Influences Control Longevity

The oldest controlled companies have multi-class capital structures in place. The average age of such firms is more than double that at controlled firms with a single class of stock. Conversely, single-class stock controlled companies tend to have limited shelf-lives – over one-half of such firms became controlled after the year 2000, compared with less than one-fifth of multi-class stock controlled firms.



Controlled Company Size Grows

The average and median market capitalization for the study's universe of controlled firms just about doubled over the period of study. The average market capitalization of controlled firms jumped from $8.3 billion in 2005 to $20.6 billion in 2015 and the median market capitalization increased from $1.45 billion in 2005 to $2.8 billion in 2015. Part of this growth, however, simply reflects broader market trends. The average capitalization for all constituents of the S&P 1500 index in 2005 was $9.4 billion and the median capitalization was $2.1 billion. By 2015, the average capitalization was $14.3 billion (1.5 times that in 2005) and median capitalization was $3.2 billion (also 1.5 times that in 2005). The evidence suggests that the market capitalization growth rate of controlled firms was higher than that of the broader market index.



Controlled Companies Generally Underperform on Metrics That Affect Unaffiliated Shareholders

Controlled companies underperformed non-controlled firms over all periods reviewed (one-, three-, five- and 10-year periods) with respect to total shareholder returns, revenue growth, return on equity, and dividend payout ratios. However, controlled companies outperformed non-controlled firms with respect to return on assets. Results for returns on invested capital were mixed: controlled companies outperformed marginally (by less than a percentage point) for most time periods, but underperformed over the 10-year period. EBITDA growth at controlled firms outperformed non-controlled company growth rates for the five- and 10-year periods, while non-controlled firms outperformed over the shorter time frames. Balance sheet metrics were also mixed.

No Consistent Difference in Stock Price Volatility Separates Controlled and Non-Controlled Companies

Average volatility at controlled firms is higher than that at non-controlled companies over the one-year and 10-year periods, and lower than that at non-controlled firms over three-year and five-year periods. Controlled firms with single-class stock structures generally have lower average volatility than both non-controlled firms and controlled companies with multiple classes of stock in all periods reviewed with the exception of the 10-year period.

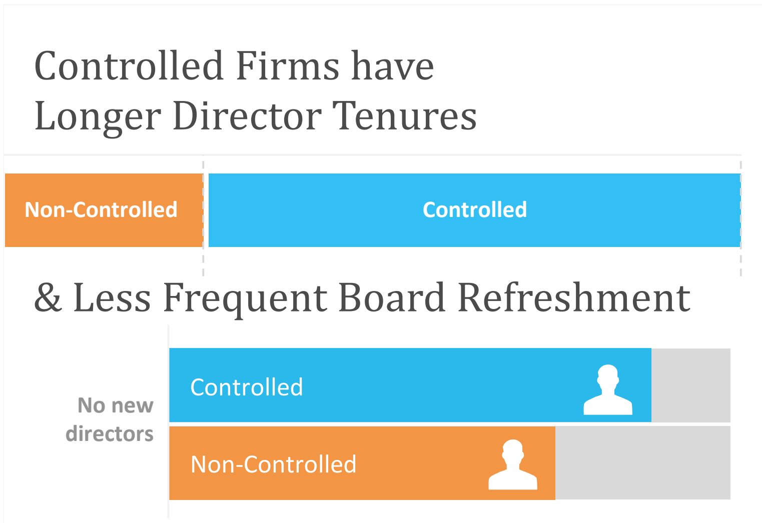
Single-Class Stock Controlled Firm Governance Resembles Non-Controlled Firms

Board and key committee independence levels, the prevalence of annually elected boards and majority vote standards for director elections, the frequency of supermajority vote requirements, and the thresholds for shareholders' right to call a special meeting at controlled firms with single-class capital structures all continue to resemble those at non-controlled firms more so than at controlled multi-class stock firms.

Related Party Dealings Continue at Controlled Companies

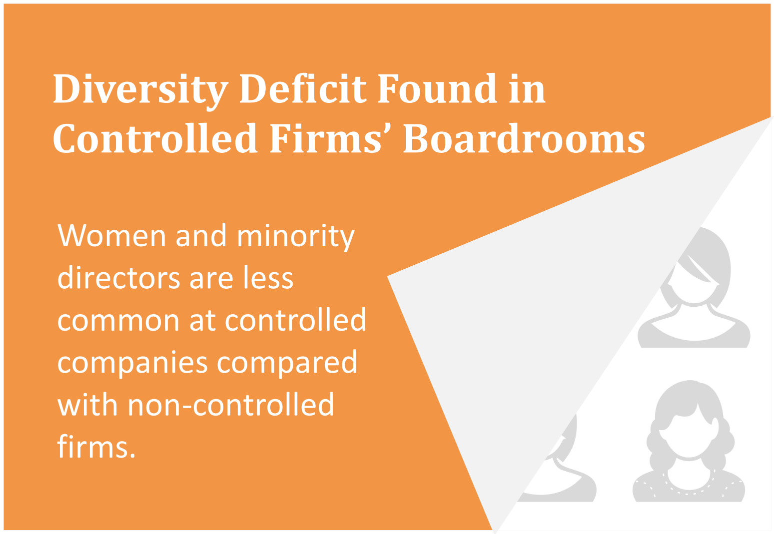
The frequency of related-party transactions (RPTs) at controlled firms declined over the study period but RPT size continues to exceed that at non-controlled firms. The average magnitude of controlled company RPTs is now $245.7 million or five times greater than at non-controlled firms – a significant increase relative to the almost identical average RPT values (of approximately $10 million) between controlled and non-controlled companies identified in the 2012 study. The size of the RPTs is affected primarily by several large related party transactions at Century Aluminum and Reynolds

American. If the RPTs at these two companies are disregarded, the average value of RPTs at controlled firms falls to $4.2 million. No controlled firms with material weaknesses were identified in this updated study compared with almost 4 percent of controlled firms in the 2012 study.



Longer Director Tenures and Less Frequent Board Refreshment Occur at Controlled Firms

Board tenures are generally lengthier at controlled companies compared with non-controlled firms and the rate of board seat refreshment at controlled entities is lower than at non-controlled companies. The proportion of controlled firms where board members average at least 15 years of board service is more than 17 percentage points higher than at non-controlled firms. Almost 80 percent of controlled firms have no new nominees on their board – roughly 10 percentage points higher than at non-controlled companies.

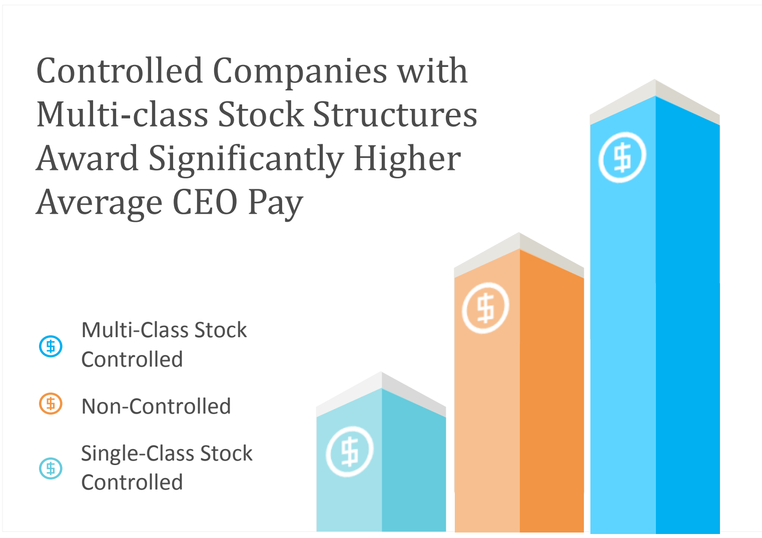


Diversity Deficit Found in Controlled Firms' Boardrooms

Women and minority directors are less common at controlled companies compared with non-controlled firms. The proportion of controlled firms with no female representation on their boards is almost 4 percentage points higher than at non-controlled firms, and the percentage of firms with two women on the board is almost 7 percentage points lower. The prevalence of controlled firms with no minority representation on the board is 20 percentage points higher than at non-controlled companies, and the proportion of firms with two minorities on the board is lower by almost 11 percentage points.

Fewer Financial Experts Serve on Controlled Firms' Boards

A lower proportion of board members have financial expertise at controlled companies compared with non-controlled firms. The proportion of controlled firms with less than ten percent of directors with financial expertise on the board is almost 5 percentage points higher than at non-controlled firms. The percentage of controlled firms with at least 30 percent of financial experts on the board is more than 9 percentage points lower.



Controlled Companies with Multi-class Stock Structures Award Significantly Higher Average CEO Pay

Most-recent-fiscal-year average CEO pay at these firms outstrips that at both non-controlled companies and controlled entities with a single class of stock.

› Average chief executive pay at controlled companies with a multi-class capital structure is three times higher (by some $7.2 million) than that at single-class stock controlled firms and is more than 40 percent ($3.3 million) higher than average CEO pay at non-controlled firms. This pay gap is largely attributable to high pay at media firms.

› Including single-class controlled companies, average CEO pay at controlled firms is 19 percent ($1.5 million) higher than that at non-controlled firms. Controlled firms with a single class of stock actually pay their CEOs less than half the broader market average (some $3.9 million less).

- Much of the pay differential between controlled and non-controlled firms is driven by the pay disparities at larger companies. The average CEO pay package at controlled S&P 500 large-cap firms surpasses that at non-controlled firms by $6.9 million and at controlled multi-class stock large-cap firms, average CEO pay exceeds that at controlled companies with a single stock class by $16.2 million and that at non-controlled firms by $9.5 million. By contrast, average CEO pay at multi-class stock controlled companies does not exceed that at both controlled single-class stock firms and non-controlled companies in the S&P 400 mid-cap index by more than $1.9 million and $74,000, respectively. In the S&P 600 small-cap index, average CEO pay at multi-class stock controlled companies does not exceed that at both single-class stock controlled firms and non-controlled companies by more than $1.1 million and $39,000, respectively.

- On the other hand, median CEO pay at all controlled companies, including both single- and multi-class stock controlled firms, is lower than that at non-controlled companies by $1.21 million. Median CEO pay at non-controlled firms exceeds that at multi-class stock controlled companies by $1.16 million, and exceeds that at single-class stock controlled firms by $2.1 million.