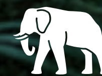
Fourth Quarter 2014



Stewart Investors
Sustainable Funds Group

Dual Share Class Blundering

"At present, more than 70% of votes are controlled by the Novo Nordisk Foundation. This gives management the ability to deflect two negative influences on proper business planning: M&A pressures driven by activist shareholders, whose only motive is scoring a run-up in the stock price; and financial reporting biased toward short-term quarterly results at the expense of long-term performance. Novo Nordisk has never been for sale, even though over the years some prominent competitors have tried to buy us. We are one of the few multinational companies operating on a 10-year planning cycle."

Jesper Hoiland, Novo Nordisk

Fifteen years ago we used to send letters to companies and stock exchanges extolling the virtues of single share classes, tag along-rights and 'one share, one vote'. Today, we actively seek out companies with dual share classes. What has changed?

Firstly, the collapse of time horizons has increased the damage that short-term markets can inflict on listed businesses. Companies lacking a long-term, protective shareholder are much more likely to succumb to the increased short-term pressures of markets. This pressure manifests itself in many ways. Currently the most obvious example is the metamorphosis of many traditional utility companies into financial engineering spreadsheets, designed to maximise ultra-short-term profitability, regardless of what damage that does to the future value of the business. When we meet with utility company management teams today, they are much more keen to discuss the dark arts that are tax shields, 'nols', reverse Morris trusts and Geoffrey the Giraffe's loophole, than water leakage rates, customer complaints or capex plans.

More broadly, short-term pressures have been responsible for the proliferation of value-destroying share buyback schemes, short-term bonuses that can be met simply through reckless balance sheet gearing and highly questionable accounting practices designed to bring forward profits.

Secondly, our appreciation of the value of long-term stewardship has increased as we have placed greater emphasis over time on the investment importance of long-term sustainability positioning.

It can take decades, rather than years or months, to manoeuvre listed companies towards more sustainable business models. The larger the company, and the older the company, the longer this can take. Only those companies with long-term stewards at the helm are able to take such long-term decisions.

Of course, dual share classes and control structures come with significant risks for minority shareholders and many of them exist for the wrong reasons. Find the right combination of structure and steward and those risks are worth the benefits. Find the wrong combination and those risks can be extremely painful.

As usual we have no clear answers. We suspect the best long-term solution may be the separation of capital markets, into a long-term, slow, long-only equity market and a high-turnover casino for short-term speculators. The former would match long-term investors' needs with companies keen to seek them out. The latter would match companies that want no-strings-attached funding with speculators after a quick bet and no commitments. The marriage versus the one-night stand!

We have no idea, however, how such a system could be designed in theory or introduced in practice. We are hoping to launch a stock exchange competition some time in 2015 to invite smarter people than us to apply their brains to the problem.

Until financial markets find a way of separating investment from speculation, we remain attracted by the idea of dual-listed share classes, and have invested clients' money in a number of such structures. We are still learning the hard way that some dual structures come with greater risks than others. For example, we were recently left helpless bystanders as the controlling shareholders of the Swiss materials company Sika sold their unlisted control shares at an 80% premium, without triggering usual takeover rules.

As the saying goes, 'by seeking and blundering, we learn'. We have been blundering as a team for over 25 years now! We have a small but growing checklist when it comes to odd share structures. Most obviously, the integrity of the steward must be beyond question. There are plenty of controlling shareholders who have repeatedly demonstrated their willingness to cut environmental, social or governance corners. It is relatively easy to spot them, thanks to our friends at RepRisk, Business and Human Rights, Wikipedia and the Worldwideweb! In the case of family stewards, assessment needs to be made generation by generation. It is neither fair nor sensible to judge the children by their parents' actions, and there are good examples of generational change leading to a dramatic improvement in the integrity of the controlling shareholder.

Secondly, we have a strong preference for a simple system with both classes of shares listed, thereby giving investors the choice between votes and liquidity. Ironically, it is often the case that the more liquid non-voting share class will trade at a premium to the voting class. In other words, the market sadly prizes liquidity over voting rights. For us it is generally the other way around.

We currently invest clients' money in a number of dual share companies where we are able to purchase the voting/control line of shares. In each case, the presence of a long-term steward is a key part of our investment case.

Third, beware of cross shareholdings and pyramid structures. They create too much scope for misalignment. This is the major drawback of many Asian control structures. It is often very difficult to work out where the strategic shareholders' interests really lie. Even when it can be identified, it is usually very hard to be fully aligned as a minority shareholder. There is much angst currently in Hong Kong on this topic after Alibaba was forced to list in the US as a result of the HKSE's strict adherence to 'one share, one vote'. In our view, a simple, transparent dual share structure where both lines of stock are listed would be much preferable to an impenetrable tangle of cross-holdings or an aggressive pyramid control structure.

In addition to these three simple guidelines, there are additional nuances we are still learning about, particularly around voting caps and takeover waivers. For example, we invest clients' funds in a wonderful Swiss engineering company formed from a management buy-out several years ago. Their reciprocating compressors can take over 10 years to design. Most of them are in operation for 30-50 years, while their longest customer relationship dates back to 1883! This is a business that greatly benefits from the presence of a long-term steward. Having seen at first hand the damage the wrong shareholder can cause, management inserted a clause at IPO stating that "the voting rights per shareholder is restricted to 5% of the total number of the registered shares recorded in the commercial register. This does not apply to shareholders who were in possession of more than 5% of the shares before the initial public offering."

We are yet to discover if the holding group can transfer this privilege to another owner, thereby selling the company under our nose at a huge premium to a new owner in whom we may not have so much belief. This is exactly what happened in the case of Sika. Similarly we still don't fully understand whether the Novo Foundation could in extremis sell their control shares in Novo Nordisk. More blundering is required!

A simple headcount suggests that at least 85% of each of our Sustainability strategies is invested in companies with a strategic shareholder. We tend to avoid open registers. We are entrusting our clients' money to long-term stewards. The challenge for us is to make sure they are the right stewards with the right structures in place. Simple control structures with listed dual share classes seem like a sensible option for listed companies in today's 'Financeland'. Perhaps in another fifteen years' time, our views will have shifted again. Hopefully this will be because there is no longer any need to protect companies from market short-termism.

David Gait

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Investment terms

View our list of investment terms to help you understand the terminology within this document

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