The Association of Corporate Treasurers

Comments in response to
Call for Evidence: The Kay Review of UK Equity Markets and Long-Term Decision Making
Department for Business Innovations & Skills,
September 2011

November 2011

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee. In this case we also sent a questionnaire including selected questions to a small sample of treasurers to add to the general picture from other inputs.

General

The ACT welcomes the opportunity to comment on this matter.

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In Professor Kay's speech he states that equity markets "provide the link between the activities of publicly traded companies and returns to the underlying beneficiaries." and that "the performance of equity markets should be judged by the contribution these markets make to improving the capabilities of companies and to enhancing the returns to investors". The Kay review focuses on the concern that equity markets have evolved in ways which do not support either or both of these objectives. More specifically Professor Kay suspects that the issue of short-termism exists and is sceptical about market efficiency.

In considering these issues and others the Kay Review seeks to understand the incentives, motivations and timescales of all participants in the equity markets, and how these affect the long-term performance of UK companies. Members of the ACT are the principal managers of funding and financial risk for companies, some of which are listed on UK stock exchanges from Plus SX to Premium Listing in London, and it is on this basis that we have provided comment to this call for evidence.

We have chosen only to answer selected questions and we believe that others are in a better position to answer other questions.

Question 1:

Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and asset managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries?

(b) What timescales are used by your company in investment appraisal and financial risk?

Companies use appropriate time frames for investment appraisal. This can be seen as varying between industries and between and within firms.

Firms in long-cycle industries, capital intensive or involving long development cycles or maintenance periods, for example advanced manufacturing like aero-engines or in heavy utilities such as energy transmission, use long, perhaps very long, time frames for mainstream investments. This can mean 30 years + if appropriate. They will use shorter periods for tactical decisions within the overall product programme.

Fast-moving consumer goods companies will typically use a shorter period for their “long-term” investments, a new factory or a complete new product line launch. For example they may use a decade or twelve years of forecast cashflows, then estimating a terminal value for any continuing activity or for remaining real option value. A similar but perhaps a little longer approach would be taken to entering a new geographical market with local manufacture and distribution. However, some seasonal product varieties involving limited capital spend and some marketing costs will be evaluated over a single season or, perhaps two or three seasons only, possibly with some value attributed to the real options of extending the life or of taking the same product on to refresh the offering for a while in other geographic markets. And tactical decision making will again normally take shorter periods. Some decisions whether to manufacture a product or buy it in will have shorter or longer term analyses according to the costs/practicality of taking manufacture back in house (the ease of which may diminish over time if skills are lost or equipment may cease to be readily available or if it would be difficult to keep up with technology without being heavily involved in the activity).

Some highly seasonal activity firms will evaluate quite mainstream activities over one year or less but evaluate things like overall brand positioning (expenditure which may be expensed rather than capitalised) over many years as being the glue that holds the company together.

Some companies regard all expenditure for later benefit as subject to capital budgeting processes, including material training programmes, premises redecoration or refurbishment for image purposes rather than required maintenance or work required for food hygiene or similar reasons.

Superimposed on that picture, however, often consideration is also given to the impact on short-term earnings, cashflow, credit rating implications and any short-term targets which the board has set executives (particularly those targets that affect rewards).

These considerations may apply to companies of all sizes. For example, an AIM listed company noted that timescales for investment appraisals varied by project but ten years would be typical for their infrastructure projects. The Treasurer stressed that this did not suggest their time horizon is limited to ten years, as they believe the business as a whole will last beyond that, it is just that particular projects may not.

(d) What timescales do you perceive equity investors, and in particular institutional investors, use in determining investment strategy?

We changed the wording of this question slightly to ask Treasurers what timescales they *perceived* equity investors have, from the original wording which asked equity investors what timescales they used.

The perception is generally that institutional investors are often focussed on out-performing their benchmark in the current year, but in doing this investors do usually take into account a company's long term strategy.

The AIM listed company, referred to above, noted that most shareholders have been very supportive of the company's taking a long term view. However they felt this might be because of their particular shareholder base and also the fact that they aren't listed on the main exchange. UK based private investors in PLUS and AIM listed companies receive inheritance tax relief which encourages long-term holding.

Question 3:

Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long term development of their business.

(c) Whether publicly traded companies pay too much attention (or feel obliged to pay too much attention) to short-term fluctuations in their share prices?

Publicly traded companies pay a lot of attention to short term fluctuation in the share price if executives are measured and reward based on share price performance or if they are aware of possible merger and acquisition activity affecting the firm as an acquirer or as a target.

On the incentive side, whilst directors and senior management can make large gains from share price movements, equal falls do not for most managers produce matching losses. One company commented that they do not take much notice of their short-term share price because they don't have any material remuneration schemes linked to the share price.

Share price movements can be viewed as a measure of how effective the company has been at getting its message about its prospects across to investors and analysts, for good or ill. Management may also feel themselves to be pressurised by the institutional shareholders about their share price performance.

(d) Whether companies feel that their engagement with fund managers and analysts is properly focused on the competitive capabilities of the business?

A large multi-national company commented that whilst competitive capabilities were a focus, current year earnings also seemed to be important to analysts in particular. A smaller company who didn't have a lot of dealings with fund managers felt that the fund managers they had engaged with had focussed on their competitive capabilities.

By way of comparison, it is interesting that rating agency analysts tend to major on a three or four year, medium-term picture, but are more interested in recent years about the company's risk management processes and liquidity position. They also look at broad long-term strategy (rather than a quantified long-term plan).

Question 8:

The quality of engagement between investors and fund managers and UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code.

(a) Whether the measures taken to stimulate engagement by investors with companies have been sufficiently effective?

No.

The wholesale movement to nominee holdings has made it more difficult for UK private investors to participate in formal meetings and votes (AGM votes and votes on remuneration packages).

While the Companies Act 2006 provides for the flow of company information to an indirect investor, an indirect investor is, broadly speaking, only entitled to copies of all communications that the company sends to its members generally. This will not normally include proxy forms and, for this reason, indirect investors will not be entitled to see the time frames within which proxies have to be delivered to the company.

Additionally, an indirect investor is required to specifically request hard copies from the company (and to provide a postal address to the company) via the nominating shareholder, otherwise he will only be entitled to information through the company's website. Indirect investors no longer see notices of AGM resolutions as a matter of routine, and this may be due to the fact that they are not aware of the requirement to request hard copies and are also not actively seeking out such notices on the company's website.

Any notices of meetings sent by a company to an indirect investor should be accompanied by a statement setting out his rights to be appointed as a proxy or have someone else appointed as a proxy or give voting instructions; however, if an indirect investor does not receive hard copies of those notices and does not actively seek out the notices on the company's website, these are rights of which they may also not be aware.

Lastly, shareholders generally will not nominate an investor to enjoy information rights unless specifically requested to do so by that investor (and even in this case, it is up to the shareholder's discretion as to whether to nominate an investor); however, investors may not always be aware of this need to request the shareholder to nominate them.

So, current provisions, while they *may* be used by really keen indirect investors with some effort are not fully effective as regards the mass of indirect investors.

Question 9:

The impact of greater fragmentation and internationalisation of UK share ownership, and other developments in global equity markets, on the quality of engagement between shareholders and quoted companies.

(a) What has been the effect of the internationalisation of UK equity markets on the priorities of companies?

(b) Whether the growth in overseas ownership of UK equities, and in the overseas activities of UK listed companies, has affected engagement between UK investment institutions and UK companies

We have not found strong views on this topic, but for some companies overseas shareholders typically take no part in corporate governance, voting, etc.

Further Points:

In addition to the comments related to the questions above three other issues were raised by our members:

- There was some concern that a number of equity market operators are too concerned about making a turn on small market movements, rather than long term investment. Exchanges encourage this activity to keep dealing volumes up. The theory that the more transactions the more liquid/efficient the market takes a fairly narrow view of efficiency. Liquidity provision of this kind, that probably dries up at times of seeming crisis, may be destabilising rather than beneficial.

- From some quarters short term selling using borrowed stock was identified as an unjustified practice by long term institutional equity holders trying to improve the return on their equity holdings. It is perceived that this practice probably creates extra market volatility. However the ACT recognise that stock lending by institutional holders is an acceptable practice and assists the smooth running of the market and settlement and clearing systems.

- Shareholders engaged in selling contracts for difference (CFDs) may leave the registered owner with no economic interest and no reason to vote. The provider of the CFD offering to vote in accordance with the wishes of the CFD holder has been criticised in the past and some major players have said that it is not their practice. The lack of motivated voters is the concern. Control of excessive remuneration or ill-considered acquisition strategies require active and thoughtful voters as part of the governance framework. And voters that will always abstain can make it harder for companies to secure qualified majorities when needed.

The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) is the leading professional body for international treasury providing the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. Membership is by examination. We define standards, promote best practice and support continuing professional development. We are the professional voice of corporate treasury, representing our members.

Our 4,200 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

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