



## ABERFORTH PARTNERS

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### Engagement and Voting framework

This document describes Aberforth's engagement and voting philosophy and practices. Separately, Aberforth's [Stewardship Policy](#) is updated annually and provides company engagement and voting examples from the calendar year.

#### Introduction

Aberforth's purpose is to deliver superior long-term returns for its clients. Thoughtful engagement and voting are likely to improve investment outcomes. Any issue relevant to a company's value can justify engagement and inform voting intentions.

Aberforth's clients are part owners of investee companies. Ownership entails responsible consideration of a company's affairs and voting on all matters at all meetings. It also entails regular engagement with directors, who should uphold good governance and promote the success of the company.

Effective engagement is a two-way process. It requires a constructive and responsible approach from Aberforth and timely consultation by boards. Aberforth's engagement is motivated not by activism but by looking after the interests of its clients.

Aberforth's engagement is pragmatic. This has proved beneficial over time and acknowledges the heterogeneity of the universe of small UK quoted companies. It also recognises that small companies can face disproportionate governance burdens. Investee companies are expected to comply with the Corporate Governance Code 2018 or otherwise explain.

Aberforth's investment process considers a company's governance structures and procedures. Governance affects a company's financial, environmental and social performances. In Aberforth's experience, good governance is a common feature of successful investments.

#### Engagement and voting in practice

##### Who

Aberforth is well resourced to allow it to undertake meaningful engagement. The relationship between Aberforth and an investee company board is led by the investment manager with responsibility for coverage of the company's sector. This individual leads on engagement and voting, but investment decisions are taken collegiately. Voting and engagement are a regular focus of weekly investment committee meetings.

Aberforth engages with executives and, separately, with non-executive directors. Emphasis is put on meetings with the chair, which is the pre-eminent role within the UK's governance regime. The chair has oversight of the executives and has ultimate responsibility for the success of the company.

Meetings with executives cover operational, strategic and financial matters. Meetings with non-executives cover strategy, board effectiveness, succession, remuneration and capital allocation. Environmental and social issues are relevant to both groups.

## Where

The preference is for in-person meetings, particularly when addressing sensitive topics. Meetings at the firm's Edinburgh office make it easier for other members of the investment team to participate.

## Discreet and direct

Clients benefit from discreet engagement, while public confrontation can hinder the chance of success. Aberforth engages directly with boards rather than through intermediaries.

## Significant stakes

This term refers to investee companies in which Aberforth's clients own more than 10% of issued equity. Larger stakes bring greater influence and greater responsibility. Aberforth does not seek board positions but prefers to work with and through existing directors.

The greater responsibility entailed by significant stakes brings additional internal controls. Significant stakes are reviewed separately by the investment managers at regular intervals. Additionally, a second investment manager is assigned to each investee company in the category. Typically, the frequency and depth of engagement rises as the stake increases.

## Record keeping

Engagements are recorded and tracked in Aberforth's investment management proprietary data system. Additional detail is logged for significant stakes.

## Escalation

If an issue arises that is likely to affect the value of an investee company or to impinge on the interests of Aberforth's clients, it will be raised with the board. The initial point of contact will be determined by the nature of the issue. If the initial engagement does not resolve the issue, it will be raised with the chair. If the chair is central to the issue, it may be appropriate to approach the senior independent director (SID).

Aberforth's active engagement means that there is an opportunity for the issues to be addressed before they are put to a shareholder vote. This affects the number of votes against and withheld votes exercised by Aberforth on behalf of its clients.

Ultimately, if engagement does not result in improvement, Aberforth may vote against any relevant resolution, including the re-election of directors, and/or seek to effect change. To help the process of engagement, a withheld vote may be considered. The recommendations of proxy advisers are not automatically followed.

Aberforth will normally inform the investee company of its intention to vote against or withhold a vote before the meeting takes place.

## Collective engagement

Since Aberforth's clients are often large holders of investee companies, the investment managers are usually able to engage directly and effectively with board members. However, there are circumstances in which collective engagement with other fund management houses can be helpful. The firm's interaction with other investors is influenced by the terms of the Takeover Code.

## What Aberforth expects of companies

Major shareholders should be consulted about significant matters, such as capital allocation and board composition. Consultation should be meaningful – i.e. it should not be the presentation of a *fait accompli*. Meaningful consultation enhances relations between boards and shareholders.

Meaningful consultation can entail shareholders becoming insiders for a period of time. It is difficult for boards to judge when to consult, since many shareholders would prefer not to be inside for extended periods for portfolio management reasons. Aberforth recognises this reasoning but also understands the responsibilities that come with effective engagement and stewardship. Therefore, Aberforth is prepared to be inside for longer periods.

## Governance topics and Aberforth's guidelines

### Capital allocation and structure

- Dividends

All companies should pay, or aspire to pay, a dividend to shareholders. Dividends evidence capital discipline and are a reminder to boards that equity capital has a cost. Furthermore, a good dividend record can lead to a better stockmarket rating over time and be an important part of total equity returns. Dividend policies should be thoughtful and set with a long term perspective. They should reflect the nature and maturity of the business. Such policies can convey additional valuable information to shareholders about the board's view of the company's prospects. Shareholders should be consulted about planned revisions to the dividend policy.

Progressive dividend policies should describe what is meant by "progressive". Policies that are linked to pay-out ratios are inadequate since they leave one of the few factors within the board's control at the mercy of profits.

- Surplus capital

When a company has capital surplus to its requirements, it should consult shareholders to discuss how to return the surplus.

Special dividends are often the best method since they are equitable, guaranteed and cost-efficient. The earnings per share enhancement offered by share buy-backs can be achieved when a special dividend is accompanied by a pro rata share consolidation.

Share buy-backs have their place too. Their drawback is often the discretion with which they are implemented – the return of surplus capital is less certain. For a buy-back to achieve the full economic enhancement to continuing shareholders, shares should be cancelled rather than held in treasury.

- Share issuance

Access to equity capital is an important motivation for a stockmarket listing. However, equity capital is permanent and the decision to raise additional equity is of fundamental importance to shareholders. Boards should undertake meaningful consultation with shareholders when they are considering the issue of equity. Standby rights issues and announcements of likely equity raises unaccompanied by pricing details can destroy value.

Directors should understand and uphold the principle of pre-emption. It is fundamental to protecting the rights of existing shareholders. However, in exceptional circumstances, such as when a company is in financial distress, it may be appropriate to issue shares on a non-pre-emptive basis.

- Takeovers

Meaningful consultation is crucial when a board is considering recommending the sale of the company or the significant disposal of company assets. A board that intends to recommend a takeover offer, risks damaging its reputation if it presents a *fait accompli* to its shareholders without consultation or with little notice.

Aberforth does not normally sign letters of intent. It signs irrevocable undertakings only in exceptional circumstances.

### Board composition

- The role of chair

The appointment of a strong independent chair is paramount: most other aspects of corporate performance and governance flow from this. Effective board oversight and leadership is essential for the preservation and enhancement of shareholder value. In normal circumstances, the chair should be independent. However, in turnaround and restructuring situations, an executive chair can be effective.

- Non-executive directors

Non-executive directors should be aware of personal capacity. Aberforth scrutinises directors' records, attendance and time served on other boards. When a non-executive has several appointments, performance on one board may influence voting decisions on another. In normal circumstances, executive directors should not become non-executive chairs of other companies. When executive directors pursue another directorship to broaden their experience, executive responsibilities should be prioritised.

The role of the SID is important, especially when the chair's performance is in question.

For all non-executive directors, a maximum tenure of nine years is preferable. There may be circumstances in which temporary flexibility is justified.

Aberforth does not seek non-executive director positions and so does not normally support shareholder-nominated directors. Such appointments risk conflicts of interest. Where boards believe there is merit in appointing a shareholder-nominated director, consultation with other shareholders should come well before the announcement.

- The size of the board

Subject to considerations of independence, a smaller board may offer advantages in terms of cost and decision-making. These advantages are particularly relevant among smaller companies. However, diversity targets may take longer to achieve with a smaller board.

- Diversity and inclusion

Aberforth considers diversity when assessing the composition of boards. It is fair that companies award roles to those best placed to fulfil them. Compliance with the listing rules or an explanation of non-compliance are expected. Engagement is undertaken if the explanation is inadequate.

In the case of smaller companies, flexibility and pragmatism are merited given scale disadvantages and the competition for managerial talent.

#### Environmental and social considerations

Aberforth's approach is rooted in the view that a company's system of governance is crucial to how ESG risks and opportunities are identified and managed. Therefore, when issues are identified, Aberforth engages with the director responsible for sustainability and/or the chair. If engagement fails to effect change, a vote against the responsible director and/or the chair is considered.

Aberforth's [ESG framework](#) details the framework for assessing companies' ESG exposures. This methodology culminates in an overall ESG evaluation for each investee company, which can inform engagement agendas and voting intentions. Engagement priorities related to ESG issues are set according to their materiality and the possible impact on company value.

The growing awareness of environmental and social issues has accentuated their effects on stockmarket valuations. Among small companies in particular, the perception of ESG deficiencies can create valuation opportunities, as the stockmarket often under-estimates the ability of small companies to take effective remedial action. In recent years, companies have improved disclosure and target-setting related to environmental and social factors. This has been helped by regulation, such as TCFD, which has standardised approaches to specific issues. Where ESG-related valuation discounts are identified, they can be challenged through a programme of active engagement.

#### Remuneration

Small UK quoted companies compete for managerial talent with private and overseas companies, which may not be subject to the same constraints on executive remuneration. Accordingly, Aberforth is flexible and pragmatic in considering remuneration proposals. This includes unconventional incentive plans designed to align rewards to directors with outcomes for shareholders. Aberforth expects to be consulted in the early stages of a remuneration policy update to allow adequate time for changes to be made where necessary.

The following bullets outline Aberforth's views on specific remuneration issues. If engagement cannot resolve concerns related to remuneration, a vote against the head of the remuneration committee and/or the chair will be considered.

- The value of awards should be reasonable when compared with the value created.
- Dilution through the issuance of options or new shares should be limited to 5% in all but exceptional circumstances.
- In normal conditions, there should be no re-testing of options or other share awards.
- Justification is required for executives' salary increases above the rate of inflation or the rate of wage increases for the broader workforce.

- Executive directors should be set stretching minimum equity ownership targets. It is preferable that this is achieved through the market purchase of shares rather than through incentive scheme awards.
- In exceptional circumstances, one-off awards may be justified to recruit high calibre executives.
- Sustainability objectives should be part of short-term bonus plans. They should be measurable and quantifiable – staging posts towards meeting longer term sustainability goals. For long-term incentive plans, objectives based on financial metrics objectives are preferred. This is because sustainability does not exist in isolation – over time, successful management of sustainability issues will affect total shareholder return and profit based remuneration criteria.
- Long-term incentive schemes should align executives’ time horizons with those of shareholders. Profit or cashflow objectives are best supported with a return on capital underpin to guard against growth through short term deployment of capital. Total shareholder return, whether relative to an equity index or to an absolute return hurdle, reflects value creation for shareholders and should consequently be an important component in long-term incentive schemes. Other approaches towards remuneration are considered, but early consultation and debate is important.
- The terms of executive departures, including payments above the contractual minimum, are scrutinised.

#### Other

- Audit

Regarding rotation of auditors, companies should comply with guidelines overseen by the FRC. Non-audit related fees charged by the auditor can represent a potential conflict of interest. Where non-audit fees are significant, the reason for the expense should be explained clearly. Aberforth may ultimately consider a vote against the chair, the chair of the audit committee, the auditor’s reappointment, or the auditor’s remuneration.

- Political donations and expenditure

All political donations or expenditure should be disclosed together with detail about the spending plans and why the outlay is in shareholders’ interests. It is accepted that the broad definition of ‘political’ under the Companies Act 2006 means it can be prudent to seek approval for certain types of expenditure. Aberforth does not support resolutions where there is the intent to make payments to a political party or any related individual.

- Proposals motioned and general meetings called by shareholders

Shareholder proposals are assessed on their individual merits. If a proposal has merit, Aberforth would engage with the chair before voting.

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