ABERFORTH PARTNERS

# Engagement and Voting framework

Regular, open and constructive engagement with investee companies is an important component of Aberforth's investment process. Aberforth thinks of its clients as part owners of companies. It therefore pays due consideration to companies' affairs and votes on all matters at all meetings. Engagement through direct contact with executive management and non-executive directors can improve shareholder outcomes and serve to inform voting decisions. If successful, these interactions can enhance corporate governance and general business practices to the benefit of value for all stakeholders. All matters – including environmental, social and governance (ESG) – that might affect the valuation of an investee company, or broader stakeholder interests, are considered and actioned.

Aberforth divides coverage of the investment universe by sector among its investment managers. Each company is therefore the responsibility of an investment manager, who leads on engagement and voting. It is Aberforth's experience that clients benefit from a policy of discretion on engagements and that public confrontation can hinder the chance of success.

The preference is for engagement via face-to-face meetings, particularly when addressing sensitive topics. Meetings at the firm's Edinburgh office also make it easier for other members of the investment team to participate. In practice, much of Aberforth's engagement is conducted through phone calls, video conferences and e-mail. Covid-19 has necessitated engagement in a virtual way. Whilst not optimal, it has proven effective in the circumstances. Should a third-party be required to facilitate meetings, Aberforth pays for the service unless it is covered by the terms of a retainer arrangement between companies and the third-party.

While interaction with executives helps to understand a company and the issues affecting it, the chair's role is pre-eminent within the UK's governance regime. The chair has oversight of the executives and has ultimate responsibility for strategy and capital allocation. Accordingly, Aberforth's engagement approach emphasises contact with the chair. The frequency and depth of engagement with the chair increases proactively as the stake held by the firm's clients rises and reactively should the investment case deviate from its expected path. Aberforth also values engagement with the senior independent director (SID). This becomes particularly relevant when the chair's performance is in question. In addition to the topics raised in executive meetings, engagement with non-executives can address upcoming votes, remuneration, executive performance, board succession, corporate strategy, environmental and social issues and capital allocation.

Aberforth maintains a flexible approach toward engagement. A pragmatic, rather than a prescriptive one-size-fits-all, approach has proven itself beneficial over time. This acknowledges the heterogeneous nature of the universe of small UK quoted companies and the proportionately greater governance burden on the typical small company.

## Voting principles

### Aberforth:

- Votes to maximise the value of its clients' capital, taking into account all relevant factors, including environmental and social issues.



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- Votes on all resolutions put to shareholders.
- Does not automatically follow the recommendations of the board, or of proxy advisers, but aims to engage with the board before voting against or abstaining.
- Believes that abstention – or withheld votes – can be a useful signal in on-going engagement with a company.
- Expects to be consulted on contentious issues before they are brought forward for voting.
- Expects companies to comply with the Corporate Governance Code 2018 or explain otherwise.
- Retains a flexible and pragmatic approach recognising that the requirements of smaller companies do not always conform with "one-size-fits-all" policies.

## Escalation

Escalation of engagement normally occurs when an investment thesis strays from the expected path. The weekly investment meeting is the forum for formal consideration of the status and effectiveness of live engagements. The investment manager responsible for the company in question leads the discussion, presenting an analysis of the situation and the progress made to date. An escalation plan is then formed in discussion with the rest of the investment team. The plan is designed to address Aberforth's concerns and proposes how, and in what time frame, they might be remedied. The first move in an escalation is usually to engage with the chair, but, if the chair's performance is under scrutiny, the focus turns to the senior independent director. The company's advisers and other investors may be contacted to inform them of the concerns. Voting is the primary means by which Aberforth can reflect its concerns and seek to achieve change. Other options include issuing a formal letter expressing concerns and/or expectations to the board, the requisition of an EGM and ultimately the consideration of divestment.

## Significant stakes

Aberforth has a formal methodology for managing significant stakes. This describes the process followed as the ownership position across the firm's assets under management increases through 10%, with a maximum upper limit of 25%. Such stakes bring influence, though Aberforth does not seek board positions. Rather, its *modus operandi* is to work with and through the company's executives and independent non-executives.

The investment manager responsible for the position reviews the company at the investment meeting where an additional investment manager is also assigned. As described above, should there be a requirement for active engagement then an engagement plan is discussed and formulated. Becoming a significant stake is not in itself a reason to escalate engagement, but it does ensure that connections with the board are established if they have not already been made. Under the provisions of the Corporate Governance Code 2018, the company chair should also be pro-actively contacting their major shareholders.

Significant stakes are reviewed collectively and formally at least once per year and are also continuously monitored on an individual basis through the normal investment process.


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## Composition of boards

Aberforth expects companies to comply with the Corporate Governance Code 2018 or explain why they have not done so. Where board structures differ from the Code's guidelines then each situation is appraised individually.

The appointment of an experienced independent chair is foremost in the consideration of board composition. Experience suggests that most other aspects of corporate performance and governance, including how relevant material environmental and social factors are managed, flow from having a good chair. Effective board oversight and leadership is essential for the preservation and enhancement of shareholder value.

In situations that involve company turnarounds and restructuring, Aberforth believes an executive chair can be particularly effective. However, it is preferred that a CEO does not become the chair of the same company on retirement from executive duties.

A maximum tenure of nine years should be observed for directors, though in some circumstances temporary flexibility might be justified.

Non-executive directors should be aware of personal capacity and multiple board positions are scrutinised. Both private and public appointments are considered when assessing directors' available capacity. If a non-executive has multiple appointments, performance on one board may influence voting decisions on another. Attendance records at board and committee meetings are monitored.

With an investment strategy focused on smaller companies, the size of the board is an important consideration. Aside from the additional cost, large boards of directors may blunt the decision-making process and blur accountability. Aberforth prefers smaller boards, with a majority of independent non-executive directors, including the chair.

Investee company boards should take employee views into consideration. Aberforth believes individual boards should have discretion as to how this should be achieved, which may involve an independent director being given the responsibility.

## Diversity and inclusion

Aberforth considers diversity and inclusiveness when assessing governance structures. Those companies able to create and sustain cultures of inclusion are likely to attract and retain the best talent. Diversity is likely to improve decision making and problem solving and so improve investment outcomes and the long-term success of the company.

It is fair that companies seek to award roles to those best placed to fulfil them. In the case of smaller companies, greater flexibility is merited, reflecting their smaller revenue and cost bases, as well as the competition for managerial talent that they face.

Aberforth encourages boards to ensure their composition reflects the wider demographic make-up of society, accepting that this may take time to achieve. Where a board is insufficiently diverse, Aberforth engages to understand how diversity was considered in the nomination process. Depending on the circumstances, and on improvements underway, Aberforth may seek to effect change and consider voting against the chair of the nomination committee.



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## Environmental and social considerations

Environmental and social issues influence the value of companies in two ways. First, sales and profits may prove vulnerable to certain industrial exposures and to the direct effects of suboptimal practices. Second, the cost of capital may be penalised if companies are seen as contributing to climate change or if their response to climate change is deemed to be insufficient.

Aberforth believes that climate change is a systemic risk to economies and financial markets. The analysis of companies includes an assessment of how their strategy and operations affect climate change, and *vice versa*, and evaluates plans to mitigate these effects. Companies that can invest proactively to diminish climate change could see improved recognition by the stockmarket. Alternatively, it is also possible that some investors might overreact to perceived climate risks and reduce company valuations such that they then become attractive investment opportunities for those following a value investment philosophy.

Aberforth believes that a company's system of governance is crucial to how its environmental and social policies are designed and implemented. It is therefore important that boards describe their approach to managing these issues. The Managers' investment process incorporates regular consideration of investee companies' governance structures and procedures. The Managers engage consistently and proactively with the boards of investee companies on governance and other matters that are material to the investment case. Many investment cases are influenced by environmental, social and governance matters, particularly as the increased profile of such issues affects the stockmarket's valuations of companies. A consistent approach to carbon disclosure is ever more important in enabling investors to make better informed investment decisions around climate change. While Aberforth does not engage in public advocacy, the firm supports the efforts being made to find a common reporting standard. Aberforth would encourage companies to disclose in line with the TCFD requirements, which will become mandatory for most companies on 6 April 2022. Sustainability related frameworks and reporting continue to evolve as evidenced by the UK's plans for new Sustainability Disclosure Requirements (SDR) and the IFRS Foundation's plan to develop sustainability reporting standards.

Engagement on environmental and social issues starts with the executives. Meetings provide an opportunity to discuss concerns and mitigation strategies or, alternatively, can focus on the level of disclosure provided on various topics. These can include labour practices, health and safety track records, water usage, supply chain practices and emission levels amongst others. The status of these issues is monitored by the investment manager responsible. In the absence of change or satisfactory progress being made, Aberforth escalates concerns to the chair which may culminate in a vote against the chair and the executives.

## Collective engagement

Since Aberforth's clients are often collectively large holders of investee companies, the investment managers are usually able to engage directly and effectively with board members. There are, however, instances when a collective approach to engagement may be appropriate. These collective engagements can occur when Aberforth considers the cumulative holdings of the firm's clients insufficient to effect change. The firm's interaction with other investors is influenced by the terms of the Takeover Code. Beyond specific engagements, Aberforth sees value in the sharing of views with other industry practitioners and through participation in industry forums.


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## Becoming insiders

Aberforth is prepared to be taken inside. It is a responsibility that comes with the investment process and with thinking about clients as part owners of companies. Similarly, it is the responsibility of boards to consult their shareholders, particularly on significant and potentially contentious matters.

The difficult issue is most often the length of time for which shareholders are prepared to be inside. On the one hand, given the practicalities of managing client capital, it is preferable to minimise the time inside. On the other hand, Aberforth recognises the need for flexibility and pragmatism, and is therefore prepared to remain inside for longer periods if this serves the interests of clients' capital. Judgement is required, but a board presenting a significant event as a *fait accompli*, either without consultation or with a day or so's notice, is likely to damage its relationship with Aberforth. In all situations, clarity is expected on the likely time scales required to reach an announcement or otherwise be formally cleansed.

Becoming inside typically occurs via a "Market Sounding" in compliance with the "Market Abuse Regulation". On being made inside, a set of procedures is followed that provides an audit trail of each event. It also ensures that affected securities are made unavailable for trading until the information has been made public.

In the event of a corporate transaction, Aberforth prefers to retain flexibility and, as a result, only considers signing irrevocable undertakings in exceptional circumstances.

## Dividends, shareholder returns and capital structure

Equity capital is permanent. Decisions to distribute, or to raise additional equity, are major events for the existing owners. Aberforth therefore seeks to discuss shareholder returns and capital structures during its regular corporate engagements. These discussions address dividends, the appropriate levels of debt for businesses and expected demands for future capital by other stakeholders including pension schemes and credit providers. Companies should be able to articulate their plans for long-term value creation and boards should be fully engaged with executives on the delivery of these plans.

Aberforth expects all companies to pay, or aspire to pay, a dividend to shareholders. It can be argued that dividends are irrelevant to the valuation of a company or even that cash is better retained within a company to be reinvested at superior rates of return. In Aberforth's experience, however, dividends are a very important aspect of capital discipline – they are a reminder to boards that equity capital has a cost, which can in turn lead to a better stockmarket rating as a reputation for capital discipline is broadly appreciated. Dividend policies should be set with a medium to long-term, through-the-cycle, view rather than being set at a pre-determined proportion of annual earnings. Aberforth expects to be consulted well in advance of any proposed negative changes to dividends and believes failure to do so reflects a lack of consideration towards the company's providers of permanent equity capital.

During 2020, and as a result of the precipitous decline in dividends, Aberforth wrote to the chair of all their investee companies to remind them of the role and importance of dividends along with the impact cancellation has on the ultimate beneficiaries such as ordinary savers, pensioners and charities. A copy of this letter can be found HERE. Aberforth does not advocate the payment of a dividend if it were to threaten the financial viability of a company but does believe that it is in clients' interests, and indeed the interests of the broader economy, to see a resilient and vibrant small cap sector in which dividends continue to play a crucial role. When a company has capital surplus to its requirements, it should discuss a return of the surplus with its shareholders. Aberforth prefers that this is achieved by


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way of special dividend: this return of value is equitable to all shareholders and can be achieved in a quick and cost-efficient manner. Share buybacks can be effective when the valuation is at a deep discount to intrinsic value. However, they can also distort liquidity and there is no certainty that they will be completed. If the objective is to reduce the number of shares in issue, then the same result can be achieved by way of a special dividend and subsequent share consolidation.

Aberforth acknowledges that access to equity capital is an important motivation for a stockmarket listing. However, the case for supporting equity issuance will be considered on its merits, with particular emphasis placed on valuation and the longer-term sustainability of the business. In situations where additional equity is needed to fund an acquisition, Aberforth is open-minded, again judging each case on its merits, but acknowledges that there is a long list of companies that have destroyed shareholder value through overpriced expansion. Boards should seek shareholder opinion on such matters before equity raises are finalised.

The principle of pre-emption is fundamental to protecting the rights of existing shareholders. Directors should understand and uphold this principle to protect the interests of existing shareholders. However, it is accepted that there might be circumstances where investee companies seek authority to issue shares on a non-pre-emptive basis. Should pre-emption not be respected, Aberforth will engage with the chair and potentially vote against their re-election, alongside votes against an associated acquisition and the equity issuance, at future meetings. Aberforth notes the recommendations of the Pre-Emption Group and continues to monitor companies' actions and voting resolutions on a case-by-case basis.

In response to the capital requirements faced by companies in light of Covid-19, the Pre-Emption Group implemented a temporary relaxation to its rules, which allowed companies to issue up to 20% in new equity without pre-emption rights. Aberforth understood the circumstances surrounding this decision, but the reinstatement of the previous 10% limit was welcome.

## Remuneration

Aberforth believes that remuneration policies should be tailored to specific circumstances but should generally encourage executives to adopt a longer-term perspective. Smaller companies compete for managerial talent with private and overseas public companies who are not always subject to the same constraints on executive remuneration. Accordingly, Aberforth is flexible and pragmatic in considering remuneration proposals.

Aberforth expects that remuneration policies ordinarily comply with the principles listed below. A vote against the chair and the chair of the remuneration committee would be considered if these principles are not upheld.

- Schemes should promote long-term value creation, aligning the interests of management with those of shareholders.
- The value of awards should be reasonable when compared with the value created.
- Schemes should be simple and transparent with clear and measurable targets.
- Dilution through the issuance of options or new shares under remuneration schemes should not exceed 10% of the company's equity over a three-year period.
- Unless there are exceptional circumstances there should be no re-testing of options.


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- Basic pay increases for executive directors should not exceed inflation without reasonable justification.
- Senior executive directors should be set stretching minimum equity ownership targets. It is preferable that this threshold is achieved through the market purchase of shares rather than through incentive scheme awards.
- Longer-term bonuses should be paid in the form of shares rather than cash, with additional minimum holding period requirements.
- One-off awards may be justified to recruit high calibre executives, but these should be the exception rather than the rule.
- The performance metrics applying to short-term bonus plans should ordinarily reflect the particular financial objectives of the company. A blend of metrics is preferable.
- Long-term incentive schemes are important in aligning executives' time horizons with that of shareholders. However, implementation can be difficult owing to a conflict of time horizons between the executives' time in role and the much longer-term prospects of the company. Earnings per share (EPS) metrics are flawed since growth can be achieved, albeit unsustainably, through the deployment of incremental capital which might destroy value. An underpin, such as return on capital, can help, but may disincentivise near-term investment despite its potential long-term benefits. Relative total shareholder return (TSR) metrics can, in the short-term, detach from operational performance, since executives have no influence on the comparator group. Nevertheless, Aberforth considers TSR metrics to reflect value creation over the long-term and should consequently represent at least half of a long-term incentive scheme. Other approaches towards remuneration will be considered, but early consultation and debate is important.
- The performance threshold applied to any financial metric should be stretching.
- Claw-back mechanisms should be in place to protect investors from fraud or misrepresentation.
- When management leave on reflection of underperformance, there should be no payments beyond the contractual minimum requirement.
- Departing executives should continue to be subject to minimum shareholding requirements for a period of time post-employment. This should be limited to shares acquired through their incentive schemes only and specifically exclude any on-market purchases made during their time with the company. A sliding scale over subsequent years would seem appropriate.
- Executive pension contributions are considered in the context of total remuneration. Evidence of progress to equalise pension contribution levels between executives and the broader workforce is expected. However, Aberforth acknowledges that contractual commitments complicate the matter of immediate implementation.


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## Other issues

Voting proposals made by shareholders will be considered on their own merits together with the affected company's response.

Audit firms should not serve for longer than 10 years. There may be circumstances where the chair of the audit committee explains why the transition plan needs to be extended. If no explanation exists, then a vote against the re-appointment of the auditor (and most likely also the chair of the audit committee) is considered.

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