The Eversheds Board Report

Measuring the impact of board composition on company performance

EVERSHEDS

FT INNOVATIVE LAWYERS 2010 AWARD WINNER

Foreword

By John Heaps, Chairman, Eversheds LLP

The aftershocks of the financial crisis of 2008 continue to reverberate around the world. From the bail-out of the UK clearing banks, to the more recent issues affecting Greece and Ireland, to the stubborn unemployment in the US, we are still feeling the ongoing consequences of what was, it is to be hoped, a once-in-a-lifetime problem.

Whilst the past few years have been unpleasant, they have also been a proving ground for businesses. There are lessons to be learnt across all sectors by looking at what the successful businesses did well and where the failing businesses went wrong. This knowledge can be used to make the recovery even stronger and provide boards with important information to help them prosper and weather the impact of future downturns more effectively.

Eversheds has used its extensive international client base and contacts across a wide variety of sectors and industry bodies to research one possible factor for achieving success, namely the composition of the board. As lawyers to some of the largest global companies we understand how important the make-up of a senior management team can be. In addition to undertaking empirical research into the correlation between board composition and share price performance, we also wanted to ask the senior managers themselves what they thought mattered most in terms of the recent performance of their board and whether there was an optimal way of structuring boards to manage risk and increase effectiveness.

Our findings are contained in the pages that follow and, we believe, make for thought provoking reading. Many thanks to all those who took the time to answer our questions. We would be happy to discuss any issues that you may wish to raise in relation to this research and the conclusions that we have drawn from it.

John Heaps
Chairman of Eversheds LLP
Direct: +44 845 497 4944
Main: +44 20 7497 9797
johnheaps@eversheds.com

Contents

Introduction

The Eversheds Board Report ('the Report') is a summary of our findings of a global investigation into the relationship between board composition and the performance of companies during the recent financial crisis. We wanted to establish if the size and shape of a board played a tangible part in the success, or otherwise, of an organisation and why that might be the case.

There were two main strands to the project conducted by independent research company, RSG Consulting Limited. First of all, we examined the board composition and share price performance of 241 of the leading global companies between January 2007 and December 2009. We took an international approach, choosing companies headquartered in the UK, continental Europe, the USA and the Asia-Pacific region.

This analysis was complemented with in-depth interviews with 50 directors from a cross section of the 241 companies involved. They were asked for their opinions on board role, board composition and board effectiveness. Findings were analysed both by region and industry sector.

This mixture of objective and subjective analysis has uncovered some important issues and, we hope, adds to the debate on issues surrounding the composition, role and effectiveness of the board – issues that have recently intensified particularly following the financial crisis.

The following pages highlight the major findings from the research, including comments from some of the individuals interviewed. The full version of the Report is available and we would be happy to share it with you. Details on how to obtain your free copy can be found at the end of this document.

"The Eversheds Board Report is a fascinating study that delves into the heart of boardrooms. From insightful analysis on board composition to understanding what really keeps directors awake at night, this timely report will prove to be of great interest to boards across the world."

Dr. Roger Barker, Head of Corporate Governance, Institute of Directors.

"How companies are run, and who runs them, has never been under more scrutiny. The key to good corporate governance is to have balanced boards, made up of people equipped with the right skills and who operate within a culture of challenge. This research from Eversheds reinforces the importance of maintaining diverse boards with a good blend of independence and experience."

Matthew Fell, Director of Competitive Markets, CBI.

"It is encouraging to see that the principles-based UK Corporate Governance structure remains at the forefront of corporate governance policy across the world and continues to act as the gold standard for financial markets, as the Eversheds study reveals. The Board Report's performance analysis across international bourses, including the London Stock Exchange, dissects the driving force behind the world's most successful companies."

Tracey Pierce, Director of Equity Primary Markets, London Stock Exchange.

Our main conclusions

Better performing companies typically had fewer directors in total on their boards.

Better performing companies tended to have a higher percentage of female directors.

There is a positive correlation between share price performance and the number of independent directors on company boards.

The serving chief executive of another organisation appears to be an asset to another's board.

Boards whose directors held numerous additional appointments had a negative impact on share price performance.

Better performing companies were significantly more likely to have a greater incidence of shareholders with a substantial shareholding.

Additional findings

- As the share prices of banks collapsed, the share prices of corporates were relatively robust and had recovered most of their August 2007 value by December 2009. Out of the 241 company share prices we analysed:
  - 156 declined
  - 2 stayed the same
  - 83 increased.

  The average fall in share price over 2007-09 was 9% for all companies in the sample.

- Hong Kong and the UK were the top performers. The best performing companies were Hong Kong companies which had an increase of 15.6% in share price, followed by UK companies in the FTSE 250 which experienced a 2.5% average increase in share price over the time period.

- Continental companies suffered the biggest drop in share price decreasing by an average of 29%. Australian companies in the sample group experienced the second biggest drop in share price with an average fall of 15%.

- Some industry sectors performed well on average, including technology (16% share price increase over the period) and natural resources (9% increase).

- The banking and finance sector was worst affected by the financial crisis with an average fall in share price of 29.1%.

- 20% of CEOs and 23% of Chairs changed between 2007 and 2009.

- Annual average board compensation dropped by an average of 22% (from £11.44m to £8.95m). Companies in the pharmaceuticals and technology sectors reported an overall increase in compensation. Companies in the real estate, natural resources and banking and finance sectors experienced the largest drop. Average total board compensation for banks dropped from £14.83m to £10.03m. Average total board compensation was highest in the US followed by continental Europe.

- There was a trend towards appointing more independent directors. This was observed in every jurisdiction (other than Hong Kong) with an increase of 2.5% across the sample group and as much as 4.7% in UK FTSE 100 companies.

Elements of a successful board

"Boards will never get it right all the time. All we can do is put together a mechanism, an organisation, a set of processes, which have a fair chance of getting it right. We don't know the future, we only know the past. And therefore we have to make judgements about the future, and sometimes we get it wrong."

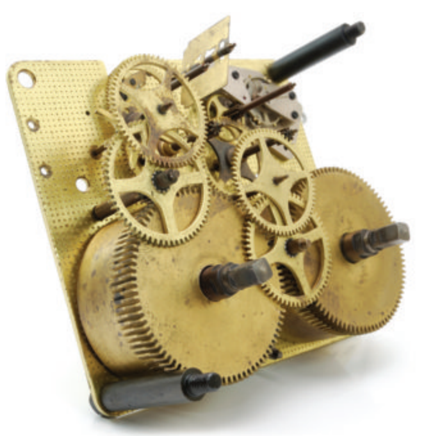
John Whybrow, Chairman, Wolseley plc

Smaller boards

Both the data analysis and interviews with directors indicated that better performing companies had fewer directors in total on their boards. This was true for Hong Kong, the US and Europe in particular.

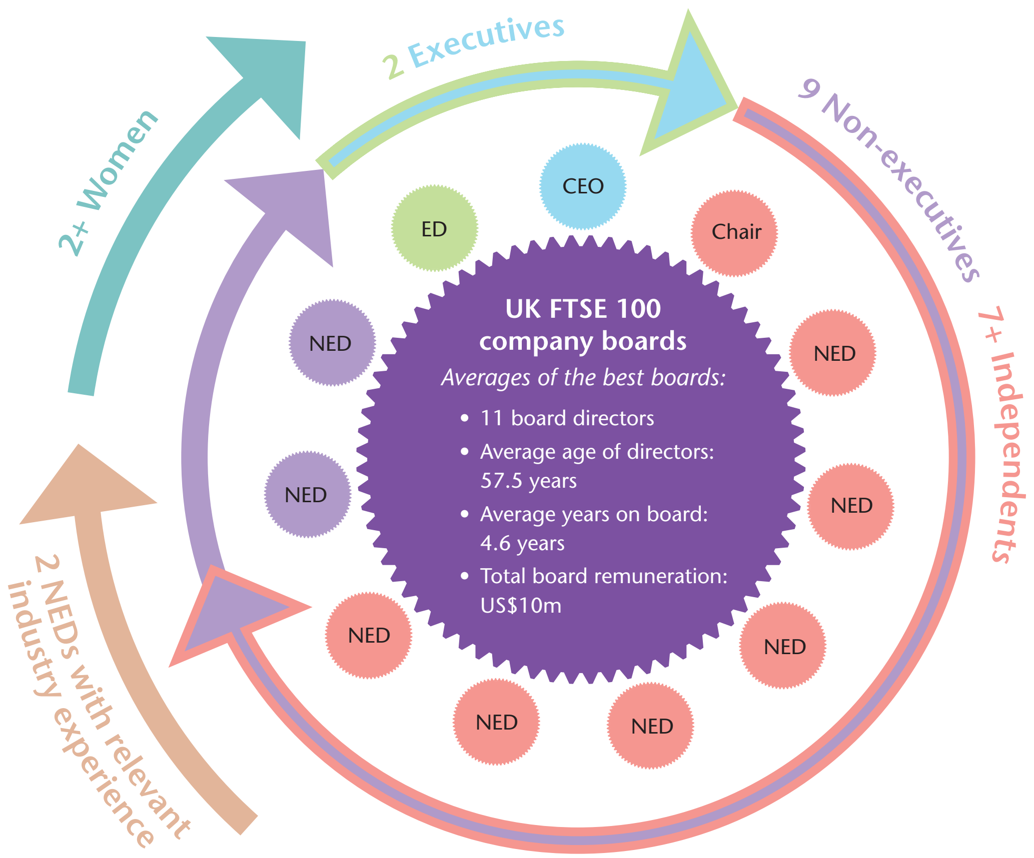
Boards in the sample group had between 6 and 32 directors, with European companies having the highest number of directors at 18.7 on average. In the Asia region a cluster analysis approach to the data clearly showed that companies in Asia-Pacific with larger boards significantly underperformed compared to companies with smaller boards.

Directors were largely unsurprised that companies with smaller boards performed better. They told us that the benefits of smaller boards were (in descending order of mentions): greater focus on the key issues; better management from the Chair; quicker decision making; and better overall dynamics between board members.



The optimum size of a board was found to be 11 directors, although there were regional and industry variations that could change this number. The average size of all the boards in the sample group was 13.4 in 2007. There was no significant change in this number during the period under review.

Ideal board composition (The average of the top 20 companies by share price)	UK (FTSE 100)	US	Europe	Asia (Hong Kong)	Asia (Australia)	UK (FTSE 250)	Banking and finance
IDEAL COMPOSITION							
Number of directors	11	11	13	11	9	5-7	15
Female	2+	2+	1+	1+	1+	1+	2+
Independent	7+	10	7+	6	6+	4+	8+
Executives	2	1	2	4	3	2	2
NEDs	9	10	11	7	6	3-5	13
NEDs with industry experience	2+	1+	5+	2+	2+	2+	2+
AVERAGES FROM THE BEST PERFORMING COMPANY BOARDS							
Average age	57.5	62.2	59.7	58.9	58.6	53.7	56.9
Total board remuneration (US$)	10m	23m	8.6m	6.3m	6.7m	2.7m	7.3m
Average length of service	5 yrs	8.3 yrs	5.4 yrs	5	3	4	3.8 yrs
Model	Unitary	Unitary	Unitary/ supervisory	Unitary	Unitary	Unitary	Unitary
Split CEO/Chair?	Split	Either	Split	Split	Split	Split	Split
Other directorships per director	2	2	up to 4	up to 3	2	2	2
Other directorships total – CEO	1	3	1	1	0	0	1



Ideal composition numbers are based on:

- *median values in 2009 for the top 20% of our sample companies in each region (excluding banking & finance boards) and for the banking & finance sector globally*
- *trends for these boards between 2007 and 2009*
- *correlations between characteristics of board composition and share price performance.*

** Best performing boards in Europe were unitary, so any two two-tier boards were excluded from the sample to get median values.*

Female directors

Better performing companies also tended to have a higher percentage of female directors – a finding which was borne out by both the statistical and the cluster analysis of the quantitative data. This finding was particularly strong for banks and UK companies.

However, only 55% of directors interviewed positively thought that diversity for its own sake was beneficial for board and company performance and only half that number were directly in favour of positive action to place more women onto boards.

Independent directors

Overall, there is a positive connection between share price performance and the number of independent directors on company boards. The finding is stronger in certain regions such as Asia-Pacific, and with industry sectors such as banking and finance.

The directors interviewed marginally preferred independence to experience when asked to make a choice. However, a majority (67%) of directors said that both were equally important when putting a board together.

However, the share price performance of companies in the sample group showed no correlation with the numbers of board directors with 'relevant industry experience', although a positive relationship was evident in the property, insurance, industrial goods and chemicals and utilities and telecoms sectors.

90% of directors interviewed did not believe that a lack of 'relevant industry experience' on bank boards had any relationship to the financial crisis. Nor did they believe that the financial crisis was caused by having too many independent directors.

The board's role

"A board has to be a combination of support and challenge. Support management until you don't, is what I always say. The moment you can't support them, you have to fire them. And challenge is very important."

Bernard Cragg, Senior Non-Executive Director, Mothercare plc

Shareholders over other stakeholders

Most directors (64%) felt that the board primarily represents the shareholders, as opposed to other stakeholders.

Minders and strategists

Directors were asked to choose between whether a board director was primarily a minder or a strategist. The majority of directors (63%) thought the board fulfils both roles although they disagreed about the correct balance between the two.

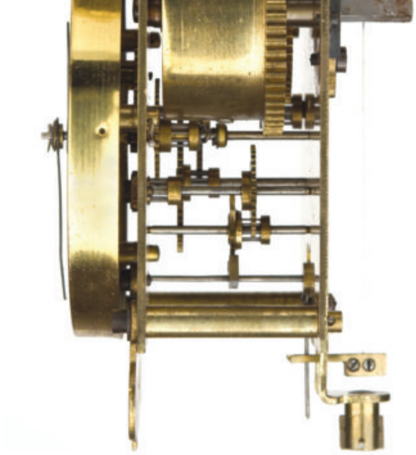
The majority (87%) of directors thought that institutional shareholders were becoming more engaged and exerting more influence on company boards. They were almost evenly split as to whether this would bring benefits with just over half (53%) saying that it reinforced short-term behaviours and decisions.

Increasing importance of risk

Whilst the vast majority of directors (93%) agreed that the board should be involved in risk management, there was little consensus as to the extent of the risk remit. Directors disagreed about the division of risk responsibilities between the executive and the non-executive directors and about what actually constituted the board's responsibility for risk.

16% of directors thought that the board should only act as a sounding board for executive management.

Board effectiveness



Competency

Directors were split over whether there was enough competency on company boards. Continental European directors tended to think that there was less competency on boards whilst directors of UK companies noted both a significant move towards a more professional approach and a variation in company boardrooms over the past ten years. Directors of companies higher up the stock indices were more likely to think that their fellow board directors or peers were competent.

"Boards are not just about selecting the best people and putting them round a table and assuming it's going to work brilliantly. Boards work brilliantly because of the relationships that are established around the table and because of a degree of mutual respect. A lot of that comes down to the behaviour of individuals."

Anthony Fry, Chairman, Dairy Crest Group plc

Tenure

On the whole, companies that benefited from continuity (ie whose directors had served longer on the board, in particular in their current board positions) fared better over the period of the financial crisis. The finding was strong for UK companies and held true for all regions except Asia-Pacific.

Despite this, around three-quarters of directors thought that length of tenure was not an indicator of the usefulness or effectiveness of individual directors.

Directors in Asia-Pacific and US companies served the longest terms (an average of eight years on the board), with the shortest terms being in the UK (4.1 years). Directors in banking and finance had served slightly shorter terms than other industry sectors on average (5.3 compared with 5.5 years).

Training

Training is considered important by a majority of directors (72%) although slightly fewer (63%) said they had not received any training. The training offered to non-executive directors still tends to be quite basic, consisting mainly of induction days, with additional sessions on law and compliance that were often arranged as an extension of the board meetings.

"In my experience, non-executive directors are not encouraged enough by chairmen and chief executives to actually participate in ongoing training, conferences, and courses."

Joe Darby, Non-Executive Director, Premier Oil plc

CEOs as NEDs

One type of individual who appears to be an asset to any board is the serving chief executive of another organisation. During the period under review, companies who had a CEO from another company serving as a NED on the board tended to perform better. This relationship was particularly significant in the US, the Asia-Pacific region and Europe.

CEOs in the US were three times as likely to hold a non-executive directorship at another company than their UK and Asia-Pacific counterparts.

Executives on the board

Although when looked at as a whole the data did not disclose significant relationships between the number of executives in relation to the board and that company's share performance, an examination of more specific data showed that certain regions displayed notable correlations on this indicator. In the UK's FTSE 100 companies and in Hong Kong, there was a significant relationship between better share price performance and fewer executives on the board. The relationship was not significant in the US as most boards only have one executive member.

External appointments

Boards whose directors held numerous additional appointments had a negative relationship with share price performance. This was particularly true in the US and Hong Kong and was also noticeable in the banking and finance sector. Directors at the top performing companies tended to hold fewer additional appointments than those at the bottom. The directors felt that the number of directorships an individual could successfully transact depended on the company and region.

Overall, most directors felt that two additional appointments represented a number that most could handle effectively.

Time commitment

Directors put the time commitment required to fulfil a non-executive director's role competently over a range of 15 to 50+ days per year. Most directors said that NEDs on average, had to spend a minimum of two days per month to be effective.

Other characteristics

When asked about the key ingredient that ensured board effectiveness, the directors' most common answer (77% of all responses) was ensuring the composition of the board right for the company, ie achieving the right balance of personalities and individual abilities, independence to experience, and non-executives to executives. The second most mentioned ingredient (50% of all responses) was the importance of an effective Chair; third (41% of all responses) was the need to challenge the executive management appropriately.

Banking and finance

“There is a lot of criticism that [banking board directors] did not know what CDO cubed was. I think this criticism is incorrect. They knew enough; what they didn’t see was the big picture, what the concept added up to in terms of the huge leverage within the system and the potential weaknesses.”

Anthony Wyand, Vice Chairman, Société Générale

Whilst banking and finance was understandably the worst hit sector by the financial crisis, patterns in board composition and share price showed the same relationships as for other corporates. Therefore, banks that weathered the financial storm most successfully tended to have:

- smaller board sizes
- a higher percentage of female directors
- a higher percentage of independent directors
- directors with fewer additional appointments (this negative correlation was stronger in the banking and finance sector than in other industry sectors).

Post-crisis change

Between 2007 and 2009, there was a greater change in the composition of banking and finance boards than in other industry sectors. Nearly a third of all directors were no longer in their post (28.2%) and the choice of new directors appointed meant that boards had more NEDs with ‘relevant industry experience’ than previously. There was a trend towards increasing the number of female, independent and non-executive directors on bank boards similar to the rest of the sample group.

More complex, less attractive

A majority (64%) of directors considered banks to be more complex than corporates. Just over half (55%) said they would not accept a non-executive position on a bank.

All CEOs interviewed, and 80% of the CFOs, rejected the hypothetical offer of a non-executive directorship on the board of a bank.

Impact on company directors

"If you've got the strategy right, it shouldn't matter what's happening in the outside world. You may have to do a bit of tacking, but in the long-term, you're pursuing your strategy."

Mike Turner, Chairman, Babcock International Group plc

No change at the top

Over half (60%) of all directors thought that the substantive role of the director has not fundamentally changed because of the financial crisis. The current focus is on how that role is being performed. However, all the banking and finance directors in the sample (ten) felt that their roles had been transformed since the financial crisis.

Increasing intensity

Every director agreed that the non-executive role has become more intense. Today, the board's top two expectations of a non-executive director are: (i) spending more time looking at the company's financials; and (ii) gaining a thorough understanding of the company's business.

Balancing act

Some Chairs have used the adverse economic conditions to push through board level changes. One Chair suggests that some boards might have become more balanced as a result of the financial crisis, but as he went on to comment: *"That tells you more about the functioning of the board before the credit crisis than it tells you about the credit crisis."*

Power shifts

The financial crisis blurred the lines between the executive and the non-executive. This power shift was the third most frequently mentioned development by directors. Many of the executive directors interviewed had not been through such difficult economic conditions so the past three years has seen them come to rely on the experience of non-executive directors more so than previously.

One Chair believes that during the financial crisis, non-executives behaved in ways appropriate to the circumstances. Now, he says, it is time for the non-executive to deliberately "pull back" and "give management more space to do their thing".

Also of interest

After board size, the strongest finding was that better performing companies were significantly more likely to have a higher number of shareholders with a substantial shareholding (ie a higher percentage of issued share capital held by shareholders who each hold 3% or more of that issued share capital).

The finding held true across all regions except Hong Kong. There was a particularly strong, positive relationship between share price performance and 'substantial shareholdings' amongst UK FTSE 250 companies, Australian and US companies.

What keeps directors awake at night?

"In life and in corporate life you need to decide whether you want to eat well or sleep well, and sleeping well must be the answer in today's environment."

Meyer Kahn, Chairman, SABMiller plc

Directors identified the following challenges facing company boards (in descending order of mentions):

1. **the economic climate**
2. **re emphasising the need for the executives, not the board, to manage the company**
3. **too much regulation interfering with the board's main activities**
4. **focusing on long term strategy and resisting short term market pressures**
5. **appointing the right management and board team**
6. **proving their own value and contribution to the company**
7. **succession planning**
8. **striking the right balance with regulators**
9. **learning lessons from the financial crisis**
10. **international expansion and emerging markets.**

Out of the other challenges mentioned by directors, incentivising management was seen as more important than managing risk.

Obtain a free copy of the full report. ***Simply e-mail us at boardreport@eversheds.com***

To see video interviews with some of the directors who contributed to this research go to ***www.eversheds.com*** and click on 'The Board Report.'

FT INNOVATIVE LAWYERS 2010
AWARD WINNER

EVERSHEDS

For a full list of our offices and
contact details please visit

www.eversheds.com

ECEN.833

FSC
Mixed Sources
Product group from well-managed forests and other controlled sources
Cert no.
www.fsc.org
© 1996 Forest Stewardship Council