

What do investors want? Views from an activist investor

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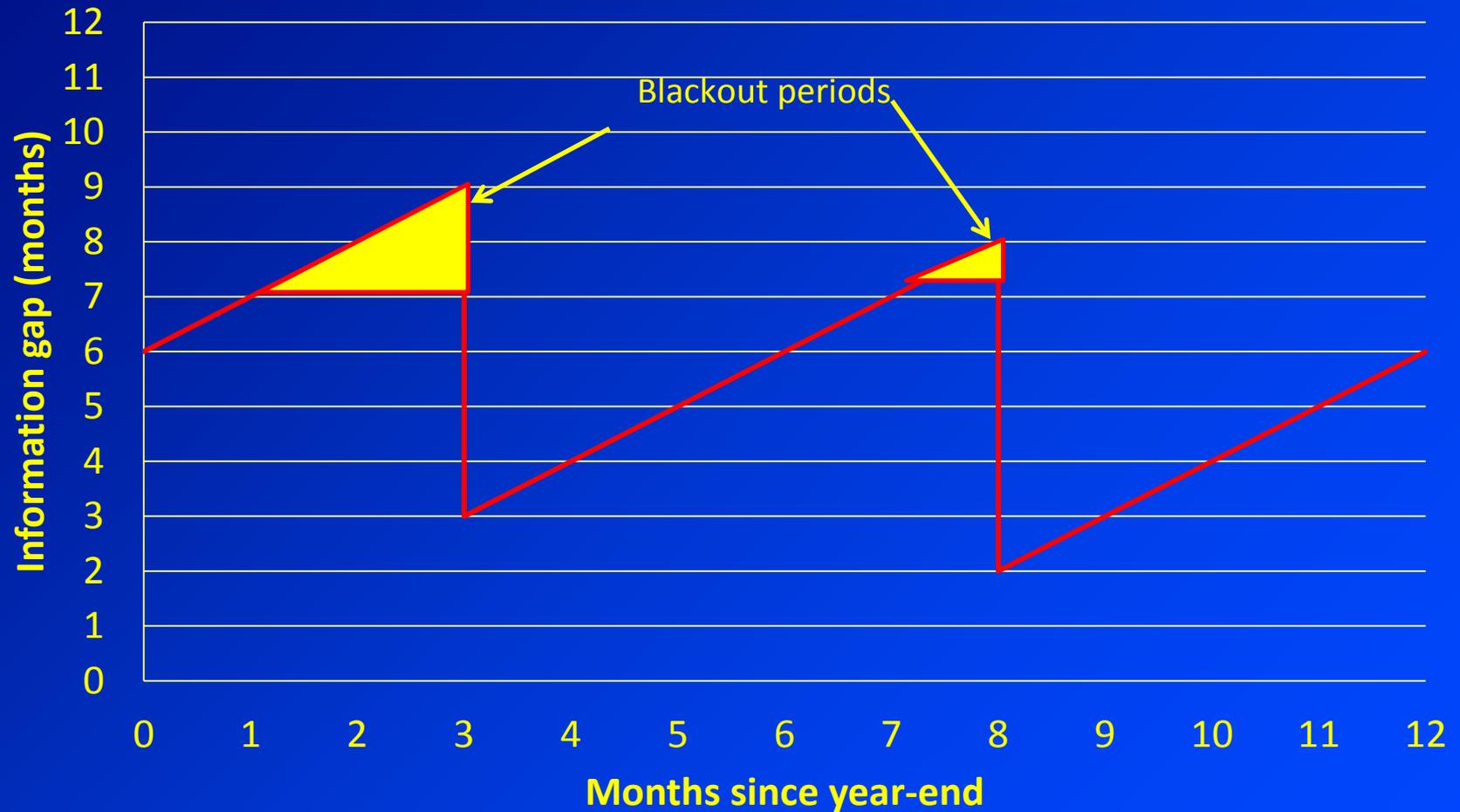
What do investors want?

- Transparency
- Accountability
- Focus on core competencies
- Good financial management
- Fair treatment
- Lack of conflicts of interest
- Good internal governance

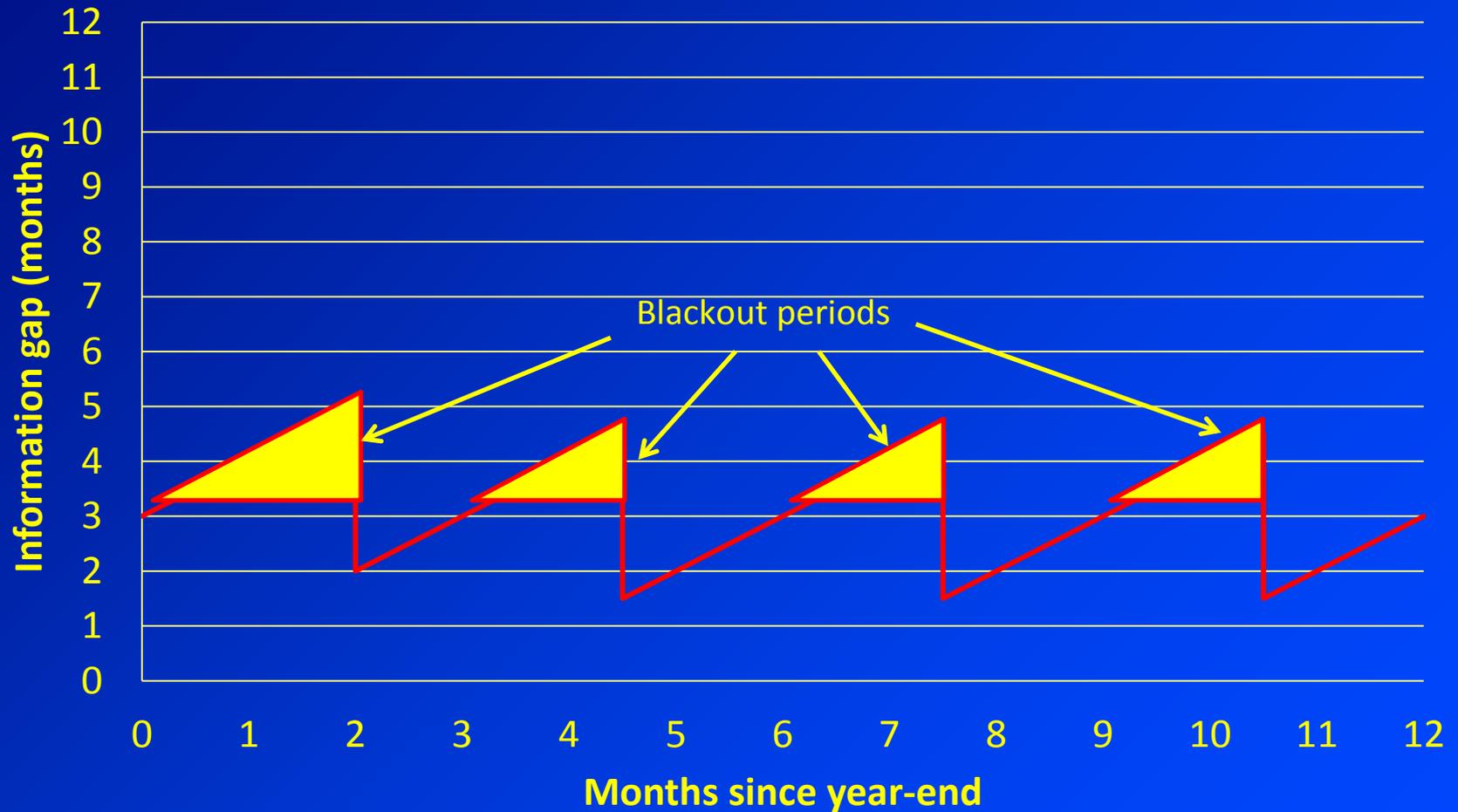
Transparency

- Tell your investors everything that you would want to know if you were holding the shares
- Quarterly financial reporting: clearer trends, fresher data
- Faster financial reporting – fresher data
- Regular business metrics – e.g. airline load factors, hotel room rates, telecom ARPU, retail same-store sales, sales per unit area
- Go beyond the minimum, don't hide behind accounting standards. E.g. disclose group FX position, not just “balances other than in functional currencies of subsidiaries”
- Business strategy and execution plan, capex plan
- Financial management strategy and plans
- Key external factors – legislative, competitive

The information gap and the blackout rule



What is achievable: frequent, fast disclosure



HK Listing Rule: All boards must have 3 INEDs



HK Listing Rule: board must have $\geq 1/3$ INEDs

- Requirement from 1-Jan-2013
- No problem! Just shrink the board to avoid hiring a 4th INED

Date	Cos. with 9 seats	Cos. with 10 Seats	Share of cos.	Share of cos.
1-Jan-2012	261	144	17.5%	9.7%
1-Jan-2013	351	66	22.8%	4.3%
21-Sep-2014	355	77	20.7%	4.5%

Accountability

- Listen to investor concerns, and act. They are only trying to improve value.
- Nominate truly independent directors
- No cross-directorships (e.g. BEA/Vitasoy)
- No multi-level INEDs (e.g. TSTP & Sino Land share 3 INEDs)
- Listing rules: INEDs opine on connected transactions & privatisations, form majority of audit and remuneration committees, but...
- INEDs are elected by controlling shareholders, so they serve at the pleasure of the King
- Until this changes, INEDs are not independent of controlling shareholders
- In May-2014, UK at last addressed this on its premium board. HK has not. Jardine downgraded its UK listings to avoid new rule
- INEDs should be elected by independent shareholders, and should report whether or not they have any concerns

Focus on core competencies

- Originally, joint-stock companies were established for specific “objects” or purposes.
- Over time, these were widened to include nearly anything, and in HK law, objects were recently abolished.
- This does not mean that investors expect companies to randomly diversify!
- Investors invest for a company’s core assets, expertise and competitive advantages, not to finance speculation.
- Listco founders often think that their success means they will be good at anything they try. Try it with your own money!
- Professional investors pick stocks, but listed companies should not.
- (To non-property companies): if we wanted to invest our money in properties, we would have invested in a property company or REIT.
- (To REITS): stay focused, return surplus cash, and don’t punt the markets with it even though the SFC says you now can.

Good financial management

- It's not enough to run a good business. You must also run a good balance sheet.
- Don't set dividends by clinging to a payout ratio. Earnings are not cash.
- Instead, produce rolling 3-year cash flow projections internally, determine your downside requirement, and pay out the rest.
- If an unexpected need arises, you can call cash with a rights issue.
- Cash piles are discounted by investors for risk of abuse.
- Cash piles are a temptation to trade debtors.
- Cash piles dilute return on equity, and reduce investor leverage. Investors hold your shares for the business upside, not for the cash. Pay it out, and they can buy more of your shares for the same capital
- Don't borrow to put the money in the bank – that is just digging a hole to build a hill, and we wonder whether the hill is there.

Dividends v buybacks

- If there is no withholding tax on dividends, then dividends are a better way to return surplus cash than share buybacks
- Buybacks can interfere with the share price, or involve the board taking a view on when the shares are “cheap”
- Buybacks can be abused to buy shares from related parties (e.g. GOME) or to prop up a share price to help a controller with a margin loan. Dividends are fairer.
- If you must use buybacks, then make them at a steady, predictable pace (except during the blackout period)
- HK Listing Rule loophole: directors cannot deal for 2 months before final results, but buybacks are allowed for another month.

Fair treatment: pre-emptive rights

- Investors own a piece of your business, not just a financial instrument. That stake should be protected.
- If you need fresh equity, then owners should have the right to maintain their stake.
- So investors vote more than 2:1 against the general issue mandate and prefer rights issues
- Shareholders should choose directors, not the other way around
- A placing discount is also an involuntary transfer of value from old shareholders to new ones
- Cut your issue mandate to 5% for cash, 20% non-cash, with max discount of 5%
- Or scrap the cash mandate as HKEx did while I was on its board. A little bit of a bad thing is still a bad thing
- Unsubscribed rights should be sold for the benefit of owners, not stolen for the benefit of an excess applications lottery
- An open offer is not a rights issue as entitlements are not transferable; it is a form of extortion: take up or get diluted. That's why UK Listing rules limit the discount to 10%. HK rules do not.

Fair treatment: connected transactions

- Investors did not buy your shares in order to lend money to your parent or fellow subsidiaries
- This is why investors vote against “Group Finance Companies”. They do not want to see a Chinese repeat of Japanese Zaibatsu, or what I call “Chibatsu”.
- Filial piety has no place in corporate governance
- If companies in the same group are so financially interdependent then they should be listed as a single entity.
- Similarly, ongoing connected transactions (supplies, sales, tenancies, services) should be minimized or zero
- Multiple layers of listings are unattractive

Conflicts of interest

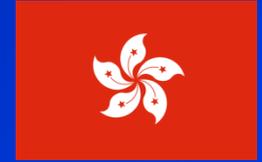
- Being a controlling shareholder and director doesn't entitle you to an extra dividend through your pay. HK Listing Rules should treat pay increases for substantial shareholders as connected transactions
- Competing interests are a turn-off. If you conduct the same activity through multiple entities, investors will assume they only get the crumbiest deals in the listed company, or in the one where you have the smallest effective stake.
- Pyramid structures raise similar issues.
- If the key management are running other non-competing businesses on the side, investors will wonder which business gets the most attention. Dedicated managers are generally more successful.
- Don't treat the listed company as a playroom for your children. If you want to finance their start-ups, do it with your own money, not ours.
- Donating shareholders' money can only be justified if it benefits the company, not you or your spouse with an honorary doctorate or a seat on a charity board. You are not paid to give away our money. We'll do that if we want to.

Good internal governance

- Good management information systems – an external indicator is the speed of financial reporting
- Board should get monthly management accounts with narrative, and update on progress of capital projects
- Budgets and cash flow projections should be updated at least half-yearly
- Internal controls – dual sign-offs, internal audit, legal & regulatory compliance, declarations of interests
- Whistle-blowing facility – allow anonymous and named complaints, by e-mail as well as snail-mail



Red flags



- Investments in securities, yachts, antiques, structured products...
- Loans to “third parties” or “entrusted loans” in PRC
- Skewed balance sheets, apparently hoarding cash while borrowing
- Repeated transactions with BVI shells, no owners disclosed (Renhe)
- Converting trade receivables into loans (Moulin, Egana,...)
- Improbably high profit margins (Ocean Grand Chemicals,...)
- “Earnest money” deposits for possible acquisitions (Egana, Tack Fat...)
- INEDs who presided over problems at other companies (see Webb-site Who’s Who for average annual returns of directorships)
- Auditors, sponsors with a disproportionate number of imploded clients (see Webb-site Who’s Who for adviser league tables)
- Multiple listed entities under common control
- Controlling shareholder not on the board (Real Gold Mining,...)
- Issues of unlisted warrants
- Excessive use of share options, particularly with non-employees
- Ongoing related party transactions for supplies or sales (Greencool,...)
- Excessively high fixed-asset costs

About Webb-site

- Founded in 1998. Not-for-profit, partly funded by speaker fees, but mostly funded by me. The site and related activity takes about half my time.
- The other half, I research and invest in HK small-caps, currently holding >5% of 12 listed companies
- Corporate horror stories end up in *Webb-site Reports* (time permitting)
- Under-valued well-governed companies go into my portfolio
- Over 20,000 subscribers to a free newsletter, opt-in/out
- Opinion polling
- Hall of Shame for jailed directors, CCB watch, SFC watch, ICAC watch
- Site also covers economic governance, advocating transparency, accountability, civil liberties, tax reform, land lease reform, minimal intervention and economically-rational policy-making
- *Webb-site Who's Who* covers all HK-listed directors, auditors, advisers since 1990; legislators, district councils, statutory/advisory bodies, CE election committee, relationships between them
- Frequent news flow from courts, tribunals, ICAC, HKICPA, SEHK, SFC and others, often with commentaries
- *Webb-site Total Returns* series – since 1994, all HK stocks including delisted
- Tracking all SFC-licensees, and all HK-registered companies (over 1 million live)
- CCASS Analysis System for stock movements

Thank you!

