IRONCOMPASS

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Principles of Corporate Governance

1. Capital Management

The Purpose of a Business

The purpose of a business is to generate cash for its owners. We acknowledge that some shareholders, boards of directors, and management teams might disagree with this basic premise; however, we view this distinction as the dividing line between a business and a charity.

Every company takes it for granted that it must describe its business to investors; this is the first section of every 10K. It should be equally important for every Board to adopt a clear policy regarding the handling of cash generated by the business, and to communicate that policy to investors. Without this, a business's earnings and financial statements lose much of their meaning. What is the value of a dollar of cash flow if the investor has no clear view as to what will be done with the money?

Best Practice Use of Cash

The best practice, default position for every company should be that free cash generated by the business will be returned to owners promptly and tax efficiently. While this should be the default, it is not the only or necessarily the best use of cash. An enterprise that can generate attractive additional investment opportunities, whether organically or by acquiring other businesses, should reinvest the capital instead of distributing it. Access to these opportunities can bring substantial value to shareholders and can be a major reason to own a business.

Providing Transparency to Investors

Companies should provide investors with the framework used by management and the board of directors to evaluate new investments, along with any other deviations from distributing cash flow to shareholders. Often stated objectives such as 'taking a balanced approach', 'maintaining dividend growth', and 'completing tuck-in acquisitions' offer little analyzable logic and thus do not qualify as an investible approach. Disciplined, well run companies generally have a specific return on capital target for new investments, and this should be a basic part of any capital investing framework. Companies that cannot articulate a threshold return on capital frequently do not have one, which in and of itself is a warning sign of questionable capital management. The guidance framework should be complemented with additional disclosures such as:

- Description of anticipated uses of funds (e.g. building a new factory, renovating stores, etc.).
- Guidance as to the portion of free cash flow expected to be re-invested.

- Especially as it relates to acquiring other businesses, description of qualitative characteristics that make an investment eligible for consideration (e.g. expanding presence in the same end markets vs. expanding into new ones, etc.)
- Historical data showing how well a company has performed against its own capital investment metrics.

Method of Returning Cash

The method of returning cash to shareholders matters little, as long as the company gives itself adequate flexibility. Share buybacks, special dividends, or other means should all end up in the same place from a corporate finance perspective. There are a few potential pitfalls to avoid:

- Recurring dividends: Paying recurring dividends can have the perverse effect of reducing shareholder returns. Companies that pay these often go to great lengths to insulate themselves from a possible dividend cut. This can include hoarding cash well beyond operating needs, eschewing debt that might reduce overall cost of capital, and skipping attractive investment opportunities. These decisions made in the name of 'protecting and growing the dividend' harm equity returns. Even where management might explicitly tell shareholders to expect variability in payout levels, announcing a dividend cut inevitably leads to questions about whether management is concerned about the business's prospects or access to capital. For these reasons we generally recommend against recurring dividends. Companies that semi-routinely pay "special dividends" get credit from investors for returning capital without these problems.
- Timing stock buybacks: Companies that buy back stock open themselves up to criticism of whether the price was a good or bad value. This criticism is misplaced. At any moment in time and at any given price, a company's owners hold stock because they view that price as a good value. Thus, a company which buys back stock at that price is acting consistent with its shareholders' perception of value. For those shareholders that view the stock as overvalued, they will sell – and also benefit from the company's buyback as providing additional liquidity to help facilitate their exit. For these reasons, except for periods of extreme dislocation (up or down), a steady pace of buybacks is usually the best answer instead of trying to time the market.
- Announcing stock buybacks to get 'credit' for the intent: The purpose of a buyback is to return capital to shareholders, not to manipulate the stock price. Too often, companies announce stock buybacks for the purpose of appearing bullish to the market rather than as a part of a long term capital management strategy. Worse, after making such announcements, many proceed to acquire only a fraction of the authorized amount paced slowly over the coming months. These actions may get a short-term 'pop' in the stock price, but do little to enhance long-term value.

2. <u>Capital Structure</u>

Large Impact

Capital structure can have a massive impact on shareholder returns. Every company should give regular, serious consideration to how capital structure decisions can be changed to maximize the risk-adjusted return to shareholders, and communicate the conclusions to shareholders. Unfortunately, the act of optimizing capital structure is sometimes pejoratively referred to as 'financial engineering' by individuals who do not understand its importance or the tools available. In all but the highest growth businesses, capital structure can have as large an impact on long-term shareholders returns as the most fundamental operating drivers. It is remiss for any company not to consider all ways to generate materially higher long-term returns on equity capital.

Guiding Principles

There is no bright line between how much debt is 'too much' and creates material risk to the equity vs. how much is an appropriate balance. This must be evaluated on an ongoing basis by companies, and especially by their boards of directors. The actions of peer group companies and the conventional wisdom about what 'growth' or 'mature' companies are supposed to do represent inhibitors to good decision-making. In a proper evaluation, the following considerations should be paramount for companies when determining their optimal capital structure:

- The after-tax cost of debt relative to the company's total cost of capital and cost of equity.
- The stability of the company's cash flow generation. For example, companies operating in extremely cyclical industries should use far less leverage than companies operating in stable businesses with low economic sensitivity.
- Maintaining sufficient liquidity to fund the company's needs, and sufficient covenant flexibility to operate the business. Two companies can have the same amount of debt, but very different financial risk profiles. An available undrawn revolver and a capital structure free of maintenance covenants are among the capital structure features that can allow a company to be levered but still maintain significantly flexibility for growth and cushion for operating hiccups.
- When borrowing money, there is no hierarchy among uses of proceeds other than return on capital. For example, funding an acquisition is not inherently 'better' than funding a special dividend.
- Capital structure optimization does not require a catalyst, but rather it is an end unto itself. Every day that a company operates with debt levels below its optimum has an opportunity cost for equity investors, who could redeploy those funds elsewhere.

Cash Balance

How much cash a company keeps on hand is equally important for capital structure optimization as determining the level of debt. The overriding principles are the same as articulated above; any cash beyond this is in effect a reduction of debt and reduces capital structure efficiency. This includes offshore cash. The decision to repatriate cash should be made based on the tax cost relative to expected uses of cash and the company's cost of capital. For example, if a company's equity holders expect a 15% annual return on equity, and repatriating foreign cash results in 30% incremental taxes, the decision to just hold that cash overseas becomes dilutive in less than two years.

3. <u>Executive Compensation</u>

Compensation for the most senior executives should be driven primarily by the long term performance of the business, and management should be exceedingly well paid for creating value in excess of the company's cost of equity. Boards too often rely upon third party consultants in order to structure executive compensation, mistaking an uncontroversial peer group average pay package for 'best practice.' The optimal shareholder-friendly package may often be different from what the consultants would advise and should include the following key elements:

- Equity incentive compensation that generates substantial wealth for high achieving managers, even if the payouts are well beyond 'peer' compensation levels. Conversely, little or no incentive value if the company delivers poor returns.
- Vesting criteria based upon stock price appreciation and/or operating excellence (e.g. margins, organic growth, while maintaining high return on capital) but no benefit solely from making the company larger.
- Vesting objectives tied to the rate of return, not just absolute increase in value.
- Base salary and annual bonus sized small relative to the equity incentives, so as to keep the focus on those larger objectives.

If a plan is well structured, over time an executive manager should become one of the company's largest equity holders, and the stock should represent the majority of the executive's net worth.

4. <u>Board Composition</u>

Corporate directors have a duty of care and loyalty to the companies that they serve. This is a matter of law and universal. Beyond this and assuming the business is not operating in the zone of insolvency, the board's duty is to represent the interests of company shareholders in maximizing the value of their equity. Boards must be focused on both absolute long-term value creation and the rate of growth. Boards have two primary levers of action to accomplish this goal: 1) hiring, firing, and paying senior management, and 2) approving (or not) budgets and capital management decisions.

The profile of a typical public company director is a current or former senior executive whose career has either related to the company's industry or has involved significant other board experience. These qualifications bring value, especially when evaluating detailed operating decisions or selecting new members of the senior management team. However, these topics only occasionally come to the board.

Boards are much more routinely required to decide on budgets, investments, and capital management matters. Directors with investing, capital markets, and similar experience have a great deal to offer in these areas, yet they are vastly under-represented on boards. These skills are different than the accounting qualifications routinely found on boards in order to satisfy Sarbanes-Oxley requirements and work with auditors. Best practice should be to have significant board representation by individuals with deep investing and capital markets sophistication. Even better if they actually own stock in the company – then they are financially aligned with the shareholders whose interests they represent.