DIRECTORS DIALOGUE *Digest*

The Future State: Agile Boards

Directors explore the future state of boards at the ninth annual Drexel LeBow Center for Corporate Governance Directors Dialogue.

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Center for Corporate Governance | 2017

Jack Brennan and Bill McNabb discuss what the rise of long-term shareholder investing means for boards at the 2017 Directors Dialogue Dinner.

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We were delighted to welcome Directors representing over 50 public company boards to our 9th annual Directors Dialogue on April 4, 2017. Each year the Center for Corporate Governance brings together a small group of world-renowned corporate directors to engage in candid and highly interactive discussions on key governance topics, informed by the latest research.

The 2017 Directors Dialogue, titled "Defining the Future State for Boards", covered topics on capital allocation, regulatory changes, disruption and strategy. The outcome of those discussions was the concept of board agility and the need for boards to be able to adapt quickly to the rapid pace of change companies face today. Those in attendance walked away with a clear understanding of the need to develop a dynamic board agenda that allows them to incorporate the forward-looking items discussed during the day's dialgoue. The idea of board agility was echoed that evening at the Directors Dialogue Dinner attended by over 300 of the region's key business leaders, where keynote speakers Jack Brennan and Bill McNabb discussed the the rise of long-term shareholder investing and its impact on boards.

This inaugural Directors Dialogue Digest provides an overview of the key insights captured during the discussions that took place at the program. We wish to thank PwC's Governance Insights Center for their assistance with this piece.

Best regards,

PATRICIA Q. CONNOLLY

Executive Director
Drexel LeBow Center for Corporate Governance

RALPH A. WALKLING, PHD

Founder, Center for Corporate Governance
Christopher and Mary Stratakis Professor in Corporate Governance and Accountability

The job of a director has never been more challenging. Boards are facing a constantly shifting landscape of disruption. How can companies compete? Where will their next competitor come from? How can they stay ahead of changes in the marketplace and consumer demands?

Companies also continue to face capital allocation decisions. What is the best use of their money, and how can they serve their shareholders? All of these questions come against a backdrop of potential new regulatory changes brought by the new administration.

Directors representing 50 public companies with market caps ranging from $300M to $240B came together on April 4 in Philadelphia for a candid, closed-door discussion of how they are confronting these boardroom topics. They engaged with experts from the SEC, large institutional investors, and investment banking and private equity investment professionals, among others. The panel discussions focused on regulatory reform, capital allocation and spin-offs, strategy and risk in an age of digital disruption, and defining the future state for boards. One theme consistently came through during the talks: the need for the board and the company to be agile and ready to make quick decisions, and, if need be, to pivot.

"We are in a 'grow or die' world now, and our organizations have to be remarkably agile. They have to have the right people in the right place at the right time, and they have to be able to make on-demand decisions in the moment."

Douglas Conant
Director, AmerisourceBergen Corporation
Founder & CEO, ConantLeadership

Staying Ahead of Changes

Bringing a Disruptive Mindset to Board Strategy

The concept of disruption is not new. Long before Netflix disrupted the movie rental business, automobiles took over the horse and buggy sector, and electric lights replaced oil-powered lanterns. But perhaps what is new is the pace of change. As new strategies emerge to leverage technological advances, change is rapid and sometimes difficult to anticipate.

> *"A properly calibrated, experienced, and skilled long-term shareholder can be an invaluable board resource. Boards are increasingly open to this possibility on a case-by-case basis. "*
>
> *Paul Hilal*
> *Founder and CEO, Mantle Ridge LP*

THINKING OFFENSIVELY AND DEFENSIVELY

The strategy discussion in many boardrooms is dominated by a concern of being disrupted, and trying to spot potential disruptors early. Boards consistently struggle with this. When PwC asked over 800 public company directors what posed the greatest oversight challenge to the board, almost three-quarters named strategic/disruptive risks as one of their top five concerns.[1]

Even if the board does believe they have a handle on spotting potential disruptors, some directors at the Directors Dialogue contended that it is not enough. Boards need to be thinking offensively as well – how can we be a disruptor? One participant urged fellow directors to look at the issue from the perspective of customers, competitors, and partners.

Customers: Do we really know what our customers want? Customers no longer buy a product; they buy an experience. What experience are they looking for, and are we delivering that?

Competitors: Examine the traditional competitors, but don't forget about "digital natives" – companies that had a digital basis from their inception.

Partners: The idea of partnering may be off-putting to some companies. But finding a partner, perhaps a digital native, can open up new opportunities.

The discussion came to a consensus: boards need to be proactive about imagining what the customer wants. They need to know how the consumer experience and expectations are changing. This can give boards a leg up in spotting

trends and shifts in the industry. But they also need to be agile enough to act quickly when they do spot a trend or opportunity.

POSITIONING THE BOARD FOR LONG-TERM SUCCESS

What should boards be doing now? First, recognize that the pace of change means that strategy, disruption and technology needs to be on the agenda at every board meeting. The board needs frequent updates - not only from management, but from third party advisors who have a different view of the industry. When PwC asked corporate directors which type of third party advisors they have used in the past year, only about one-third said they have used external IT or cybersecurity advisors.[2] It is time for those boards that do not engage third parties to rethink that approach.

And the board needs to examine its talent to make sure they have the right people in the room. Although many of the directors agreed that board members should have multidisciplinary expertise, other directors believed boards should be refreshed with special purpose board members. Does the board have a director with experience in technology or a background in Silicon Valley? Does the board have a director with an entrepreneurial mindset, or expertise in a relevant scientific field? One Directors Dialogue participant stated that every board should give one large shareholder a seat at the table to ask the questions others won't, and to help push the other members to think a little differently.

The board also needs to push the company to think about new spaces, and experiment with new ideas. However, not every company believes they have the resources to devote to untested ventures. But one experienced director at the Directors Dialogue shared ways that even a small company can find big ways to invest in the future. He recommended implementing an "innovation sandbox" – a space where the company can experiment on a small scale without risking its brand.

By using an innovation sandbox, the company may be able to bring in unique partners and test new ideas and methods. If the experiments are successful, they could be integrated into the larger business.

Companies don't always need to invest significant dollars to learn a lot. They just have to be willing to explore options, implement promising ideas, and abandon projects that are not working.

[1] PwC, 2016 Annual Corporate Directors Survey, October 2016.

[2] PwC, 2016 Annual Corporate Directors Survey, October 2016.

Re-thinking Capital Allocation

Traditional investors and activists continue to focus on how companies are deploying capital. The capital allocation process needs to be robust, and the board has a key role to play. It's not just about figuring out the right areas of growth to invest in, or how to fund an acquisition. As one director put it: it's not your money. If you can't find the right way to use it in the company, then you should give it back – through buybacks or dividends.

But, at the same time, many shareholders clamoring for buyback or dividends are viewed as being overly focused on short-term value creation. Some activist hedge funds in particular, who may not be committed to investing in the company for the long term, often look for quick value generators, perhaps at the cost of long-term investments or strategic commitments. So how do boards go about weighing all of these options?

TYING CAPITAL ALLOCATION TO STRATEGY

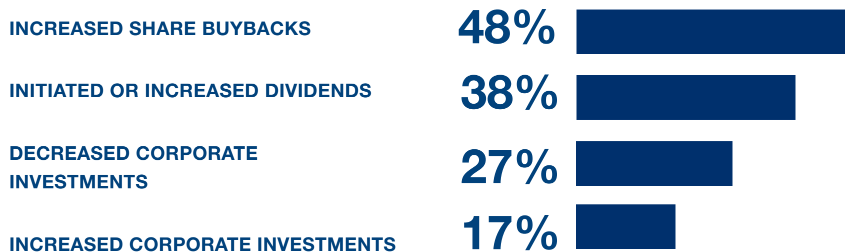
Capital allocation needs to be a part of the strategic planning process from the start. Dividends and share buybacks are popular, partly because we have been in a low-growth environment since the financial crisis. When PwC conducted its Annual Corporate Directors Survey last year, the most common action a company took in response to investor demands was to increase its share buybacks. The second most common action was to increase dividends.

But at the Directors Dialogue, some directors shared their view that a company shouldn't be doing buybacks or granting dividends just because shareholders are pushing them to do so. The company's capital allocation needs to relate to and promote its long-term strategy.

They also contended that board members should not be afraid to challenge the conventional wisdom. One experienced director offered the example of a blue-chip company that has an idea of itself as never being a "below AAA-rated" company. But the path forward for that company may require a change in mindset. He said that boards need to be open to challenging the historical conventions of their companies, and having a lively discussion about alternatives. They need to look beyond the traditional routes and be able to make decisive changes.

On M&A, directors at the Directors Dialogue encouraged looking

Has your company made any of the following changes to its capital allocation strategy to be responsive to actual or potential investor demands?



Base: 548 Source: PwC, 2016 Annual Corporate Directors Survey, October 2016.

hard at the returns from that capital investment. One director was surprised at the number of companies that do not have a disciplined post-acquisition review process. To have a balanced capital allocation strategy, he said, the board should spend as much time determining the returns on acquisition activity as it does talking about dividends and buybacks – which sometimes seem to get all of the attention.

ENGAGING WITH SHAREHOLDERS

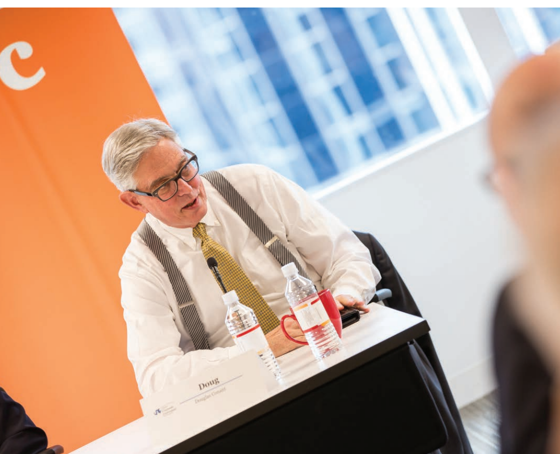
When companies engage with shareholders, capital allocation is nearly always on the agenda. Several directors shared that when the topic comes up, the shareholder's question is: buybacks or dividends? Directors need to help to change the conversation – in part because the pace of technological change is so fast. Any company not investing capital in staying ahead of the curve will soon find itself falling behind.

When a shareholder wants to engage with the board about returning cash via buybacks and dividends, companies should be prepared with real data about the value creation that comes from their M&A activity. That can add a more nuanced perspective to the conversation, bringing it from a "buybacks or dividends" discussion into a wider view of the options available.

What about the tension that seems to build between some companies and shareholders, especially activists? Directors encouraged engagement in a non-controversial way. Understand what the activist is looking for and why. It's easy to feel embattled when an activist shows up, but the board might lose perspective. One director shared the experience of a two-year battle with \an activist that resulted in a proxy fight.
When it was over, the board saw that there were things to be learned from the activist's position, and ways the company could be improved. He encouraged fellow directors not to think about such situations as win or lose. Instead, think of it as a two-way relationship that can be worth the time put into it.

Directors were also urged to make sure that their company's investor relations team is connected with corporate governance professionals. Many times, the functions are carried out by two separate teams who are not talking and may not be on the same page about shareholder engagement.

Positioning for Upcoming Regulatory Changes



With the new administration policy agenda still in the early stages, board members are all wondering what changes in laws and regulations will come, and where those changes could lead. While that agenda is still being formed, one thing is already clear: companies and their boards need to be prepared for change. Directors should expect a pause on implementation of Dodd-Frank rules, and a rollback of some of the already-adopted provisions that, in the new administration's view, create an undue burden on companies. Boards may also expect a greater emphasis on facilitating capital formation from regulatory agencies under the new administration.

The boardroom is unlikely to see new regulations governing how a company needs to operate at the board level. Some in the room stated that the number of public companies listed in the US is falling in part due to the high compliance and regulatory cost of being a public company. The cost of initial public offerings was lowered somewhat by the reforms implemented with the JOBS Act, but there may also be ways to ease the burden and make being a public company more appealing. There is ample investor money available in the private markets, but since private investments are tightly limited by the securities laws, most ordinary investors do not have the chance to invest in those companies.

Directors need to anticipate the change coming, and be ready to help the company react quickly to a new regulatory environment.

Creating The Agile Board of the Future

PUTTING IT ALL TOGETHER

Directors at the program overwhelmingly agreed that they need the right board composition to face all of these challenges: directors who are curious and well-informed; and directors who have solid background knowledge and experiences, but who are willing to take the perhaps uncomfortable role of challenging management.
What did the Directors Dialogue participants believe are the most important ways boards will need to be different in the next three to five years?

- **Shift towards future focus:** Directorship is more demanding today than it once was and companies face much more serious global competition and risk. Directors need to work with management to drive sustainable long-term value creation.
- **Re-thinking human capital management:** One director who is a former CEO said that the single most important job of the board is to choose the right CEO. But even beyond that, the board needs to take an active role in attracting and retaining the right people who can position the company for success.
- **Board engagement:** The most effective directors do not just rely on their personal knowledge of the company and the pre-read board materials. Rather, they think deeply about governance and processes as it relates to company strategy. Directors need to find the balance between being engaged and not getting in the way of management's day-to-day operations. Today's directors should help the CEO be the CEO.

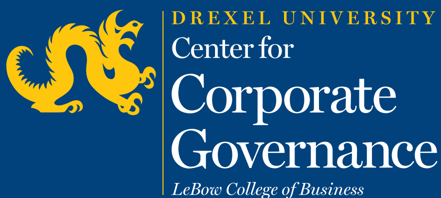
One director urged smaller companies that may believe they don't have the resources to devote to good corporate governance to look to role models in the marketplace who are leaders in corporate governance and who are creating the playbook, and describing in their proxy statements the policies and practices that make them leaders in corporate governance.

Large and small companies alike should take the time to think about the challenges they face now, and will face in the future. By looking for ways to update their practices, refresh their ideas in the board room, and identify problems early, boards can remain agile and prepared for the future.

With special thanks to Leah Malone & Paul DeNicola of PwC's Governance Insights Center for their collaboration on this piece.

THE DREXEL LEBOW CENTER FOR CORPORATE GOVERNANCE advocates leading boardroom practices through programming and research. With the support of its prominent Advisory Board, representing over 50 public, 42 private, and 48 nonprofit boards, the Center for Corporate Governance provides a collaborative environment for meaningful dialogue between directors, executives, regulators, and industry experts.

Through signature programs including Directors Dialogue, Directors Academy, Directors Roundtables, and Webinars, the Center serves as a leader in developing and advocating meaningful, substantive positions for corporate governance to guide directors and other practitioners as they lead and advise corporate boards and discharge their fiduciary obligations.



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