Charting the right course
Insights on board governance for US IPO-bound companies
In today’s hot market, the path from IPO to an index such as the Russell 3000 can be a short one; some companies make the leap seemingly overnight. Such success is a testament to vision, drive and hard work. And it’s a call to action.

A company that moves quickly from offering to a place on an index can face a change in its investor base. The new investors are those who more actively follow the governance practices of their portfolio companies. Some of these companies are hot stocks early on that attract wide institutional investor interest, including mutual funds, hedge funds, pension funds and other asset managers around the world.

Investors are challenging companies across a wide spectrum of governance practices as their influence in the boardroom has grown. In response, many companies have made governance changes to demonstrate a meaningful level of responsiveness – with larger companies leading these efforts.

In particular, they are seeking:

- Independent board leadership
- Annual director elections
- Diversity and independence in board composition
- One share – one vote

To provide a useful benchmark for discussion, we have conducted extensive research into the governance practices of companies in the Standard & Poor’s 500 index (S&P 500) as well as companies that went public in the US and were included in the Russell 3000 in 2013.¹

For a variety of reasons, IPO companies generally have some distance to travel before attaining what investors would consider maturity when it comes to governance. Some investors may give new IPO companies time for their governance practices to evolve. Companies that can boast of strong financial performance or solid reputation – or, even better, both – are likely to enjoy some leeway.

The not-so-good news is that financial results and reputations can change, and do so with alarming speed. That’s a thought that should give pause to both public companies and those looking to go public soon, because sustaining valuation after the IPO is key. It can take years to make up the ground lost during a post-offering malaise. Companies that work to secure investor confidence early can improve their post-IPO valuation outlook.

When analysts and investors believe that a company is well-run, with accountable and transparent governance, they are more likely to give it the benefit of the doubt during a rough patch. Demonstrating good governance practices, or robust plans to establish and finalize those practices, helps companies cultivate investors and equity analysts alike.

Investor expectations of corporate governance practices and transparency continue to rise, and EY research shows that governance practices are evolving accordingly. To attract maximum long-term investor support, leading IPO-bound companies should develop a plan to incorporate these expectations into their practices as early as possible.

¹ All data is from EY’s Corporate Governance Database.
**Independent board leadership**

Among S&P 500 companies, independent board leadership – whether in the form of an independent chair or lead director – has grown substantially in recent years. In 2002, just 8% of S&P 500 company boards had independent board leadership. In 2013, 71% did – mostly in the form of independent lead directors who set board meeting agendas, control the flow of information to the board and convene non-management directors.

By contrast, just over half of IPO companies have independent board leadership. Interestingly, IPO companies often begin life as a public company with separate chair and CEO roles, but move away from this structure by combining CEO and chair duties when they bring on a new CEO.

**Director elections**

Large companies are moving away from classified boards, in which directors are elected to staggered terms, and from plurality voting in director elections, where a director can be elected with the support of just one vote. A classified board has traditionally formed part of companies’ defenses against hostile takeovers; today, the value of these measures in terms of takeover avoidance has been somewhat discounted. Instead, large companies are focusing on demonstrating greater board accountability to investors. And given this momentum, investors are now looking at smaller companies to adopt these measures as well.

Given the more concentrated holdings common at newly public companies, these measures are relatively rare. Among companies in the S&P 500, 87% have annual elections, while 85% have majority voting. Among 2013 IPO companies, 25% had annual elections, and just 3% had majority voting. As these IPO companies mature, they will be expected to follow the growing trend. Companies that can demonstrate that they have plans in place regarding director elections and majority voting are very likely to fare better with investors.
Board composition

One area that has attracted a great deal of investor attention in the past few years is that of board composition. As an IPO company’s strategy shifts, so too will the composition of its board. Investors want to know about the board’s skills and experience, and how directors are positioned to help the company grow, compete and take advantage of market opportunities. At the same time, investors have not been shy about their expectations of gender and ethnic diversity, as well as independence.

Worthy societal goals aside, diversity is good for boards and their companies – gender diversity in particular. In a recent survey, the Credit Suisse Research Institute found that companies with women on their boards showed higher than average growth (14% vs. 10%) and a higher return on equity (16% vs. 12%). Boards that add women directors gain a more diverse perspective and tap into a large and growing talent pool. They also deter the highly likely possibility of becoming a target for engagement or shareholder proposals on the diversity issue.

This is one area where IPO companies have an opportunity to move beyond more mature companies. Although IPO company boards tend to be seriously lacking in gender diversity, IPO companies have an advantage mature companies often do not – that of flexibility in changing the composition of their board. As it stands, while women directors make up 18% of the boards of S&P 500 companies, they make up just 8% of IPO company boards. Technology IPOs, in particular, tend to feature little in the way of gender diversity on their boards.

On the independence front, lawmakers and regulators have drawn the lines, establishing minimum thresholds, and most companies have voluntarily gone further. On most boards today, all but one or two directors are now independent. And while controlled companies are not required to have a majority independent board, most do. Eighty-four percent of directors at S&P 500 companies are independent, versus 67% at IPO companies, a number that will naturally rise as IPO companies grow their boards and meet regulatory requirements.

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Gender diversity
Female directors as a percentage of the board

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<th>2013 IPO companies</th>
<th>S&amp;P 500 companies</th>
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<tbody>
<tr>
<td>Gender diversity</td>
<td>8%</td>
<td>18%</td>
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Board independence
Independent directors as a percentage of the board

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<th>2013 IPO companies</th>
<th>S&amp;P 500 companies</th>
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<tbody>
<tr>
<td>Board independence</td>
<td>67%</td>
<td>84%</td>
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1 Gender diversity and corporate performance, Credit Suisse Research Institute, 2012.
One share, one vote

Nearly all investors believe that each share of a public company’s common stock should have one vote, and that investors’ voting rights should be proportional to their holdings. Experience has taught investors that concentrated voting power in the hands of insiders can lower boards’ accountability and increase governance-related risks.

Companies with dual- or multi-class shares are increasingly being targeted by shareholders; officials at CalPERS, the largest public pension fund in the US, have even considered a boycott of IPOs where a dual-class structure exists.2

IPO companies, which are two to three times more likely to have dual-class stock than more established companies, are best served by moving away from such a structure. But the challenge can be formidable; with the thorny issues of voting control and potential dilution of public shares, dual- or multi-class structures can be exceedingly difficult to dismantle.

The way forward

Meeting, or having a plan to meet, investor expectations on governance is a leading practice. Companies that demonstrate their maturity or their willingness to mature are more likely to sustain investor and analyst interest, which could help cushion volatility after the IPO. Here are some simple steps every IPO-bound company should consider:

- Identify the gaps between your company’s practices and investor expectations
- Develop a plan to close the gaps and take action in the short term where prudent and feasible
- Disclose the plan to investors to demonstrate commitment to good governance

A successful IPO company can land on an index almost overnight, a move that brings with it the attendant expectations from institutional and large investors. Having a plan to meet those expectations is key to cultivating investors and analysts — and an important element in long-term success in the markets.

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We’re here to help.

This publication was a collaboration between the EY Global IPO Center of Excellence and our Center for Board Matters.

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