Board and Executive Search

A Market Update

Autumn 2018

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BOARD AND EXECUTIVE SEARCH: MARKET UPDATE AUTUMN 2018

Given the backdrop of significant political and economic uncertainty, it is perhaps surprising that the executive search market remains robust. Brexit is the issue on most people's minds, but there has been remarkably little concrete impact as yet. Indeed, many London-headquartered organisations appear to be more worried about a government led by Jeremy Corbyn, than even a 'no-deal' Brexit.

With 75 per cent of revenues for FTSE 100 companies coming from overseas and 50 per cent for the FTSE 250, UK-headquartered businesses have long been fundamentally outward facing in their focus. Brexit is hardly the only political and economic unknown in the world today, so international uncertainty adds an extra layer of volatility. However, we observe an increasing degree of resilience and resignation. In the absence of any radical short term changes, most firms seem to be focusing on business as usual. Having said that, we are seeing a number of specific industry trends:

Healthcare

The UK continues to be seen as a global centre of research, demonstrated by AstraZeneca's scheduled opening of its new R&D centre and Head Office in Cambridge in 2018 and the recent commitment by companies, including GSK, Merck and Qiagen, to building R&D hubs here. With this sector set to generate 250,000 jobs over the next 10 years, we anticipate that the competition for talent will become increasingly fierce.

Consumer / Retail

In consumer goods, the fallout from 3G's failed takeover attempt of Unilever is ensuring that cost structures are under intense scrutiny everywhere, but there remains strong demand for leaders who can drive profitable growth and harness the power of data to drive differentiation. In UK retail, the twin challenges of higher import prices and weaker consumer confidence make this a difficult time, exacerbating the structural consequences of ever-increasing online expansion. These factors have prompted a series of top management changes as Boards seek to equip themselves to succeed in an ever more competitive multi-channel world.

Financial Services

The shape of UK Financial Services continues to shift, with the impact of technology and customer demand having a fundamental effect on traditional business models. The ground previously held by established financial institutions is being encroached upon by challenger businesses keen to take ownership of customer engagement, from start-up firms to big technology businesses. As a result, some of the scale incumbents risk being relegated to the role of a utility over the longer term.

Financial institutions continue to fight a war on two fronts: regulation and technology. Boards have busied themselves assembling teams suitably equipped to help them make the right bets in next couple of years. For now, regulatory scrutiny is still providing a defensive buffer against technology businesses, although there are signs that this is starting to gradually lift. Unless they continue to maintain momentum in countering this threat, some financial services companies are in danger of becoming complacent as increases in interest rates drive profitability.

Despite these significant challenges, the senior recruitment market continues to be robust in the main and we see significant opportunities ahead for companies willing to think differently.

A premium on experience: wisdom over youth?

In an increasingly uncertain world (both politically and economically), we are seeing experience often prioritised over youth and potential. This is a consistent picture across the FTSE 100; there are currently 14 CEOs under the age of 50 in the FTSE 100 compared to 33 in 2010.

There has been a similar trend in FTSE 100 CFO appointments where we are seeing a premium on established CFO experience driving the proportion of 'lateral' external appointments from 30 per cent to nearly 70 per cent, with many of these appointments drawn from CFOs at other FTSE 100 or FTSE 250 companies.

Whilst understandable in the circumstances, this collective conservatism continues to limit diversity on all levels. In a world where companies need to create a consistent long term pipeline of female talent, it is most likely that the big steps up will come through internal promotion.

The real dangers of Narcissus

A couple of years ago, we wrote a paper on 'Taming Narcissus: Managing Behavioural Risk in Top Business Leaders' which remains as pertinent today as it did then. Boards need to be cognisant of the dangers of allowing business leaders to have unfettered power, putting behavioural risk and succession planning firmly on the agenda from the point a CEO takes office. (See our full report: Taming Narcissus). There have been several well publicised examples this year at leading listed companies, in the UK and overseas, of CEOs, having been given too much autonomy over a long period of time, ultimately having to be relieved of their roles after causing significant damage to the business.

Remuneration – a potential time bomb

Pressure on executive pay is an issue which continues to gather momentum and should be at the forefront of many Boards' agendas. As we have discussed previously, the underlying truth is that FTSE 100 CEO pay is now 150 times average worker income, a ratio that has doubled in ten years and has grown substantially faster than any sensible company performance measure: 4x market cap growth; 3x EPS, 5.5x revenue, 2.5x PBT, and 2.5x EBITDA.

Given the wider political environment, we believe the debate will come to a head and a media-driven public response could potentially force the government to take control of the issue. Perhaps disappointingly, we see a degree of complacency in some Boards which cite fewer 'against' recommendations from ISS and shareholder acceptance of Remuneration proposals as evidence that all is now well. However, we see a ticking reputational time bomb with substantial executive payouts expected in the near future, as LTIPs granted during the post-crash era mature, inflaming the issue of income inequality and the relationship of executive pay to real performance.

With no Board wanting to be seen to pay in the bottom quartile, it will, in our opinion, take a concerted effort across the FTSE 100 to redress the balance, in particular with new appointments. Companies need to unite in taking a lead in this debate; it would be a shame if business lost the right to be heard on other issues because of a loss of credibility over the pay of a small number of executives. In reality, with over two-thirds of CEOs internally promoted, it is unlikely that, if handled sensitively, those individuals would turn down the role to which they have spent their entire career aspiring over a reduction in salary.

The digital carousel

Whilst digital skills have been in high demand for a number of years now, we see this reaching a new level. Increasingly, businesses across all sectors are facing the threat of cyber-attacks as well as digital disruption with recent high profile victims including Reckitt Benckiser, Talk Talk and Equifax. This is an unfamiliar and constantly evolving threat for many leadership teams which is made worse by a finite pool of well-informed, best in class technology leaders with the weight and experience to be true advisers to the Board and executive team. This results in a constant carousel of technology leaders who stay for a relatively short period due to high demand and the big salaries they can command.

In order to address a chronic shortage in talent, companies need to be creative and courageous in developing a younger, more technologically savvy pipeline of candidates internally. One interesting parallel is in the government agencies, where an inability to pay commercial rates has led to employees being identified and then developed if they have an interest in and aptitude for technology – this pushes the talent pool beyond the traditional STEM graduates into a much wider universe.

A breakdown in trust

One of our key observations is that there is a danger of a fundamental breakdown in trust between institutional investors and public company Boards in the UK. This is beginning to impact on a range of issues and makes the model of 'explain or comply' more and more difficult to sustain. Both the institutions themselves and the increase in highly vocal activist investors have an underlying assumption that, if Boards do not comply, then they must be doing something wrong.

This is compounded by the rise of the passive investor which changes the dynamic. In a cost-conscious world, investors choose to outsource this to the likes of ISS who enforce blanket rules around issues including remuneration and 'over-boarding'. The latter is becoming an increasingly high profile issue and, whilst in some cases these concerns have legitimacy, there are a range of NED models with many treating their portfolio as a full time job. Ultimately, in a well-functioning environment it should be about trust and communication rather than a 'magic number' of Board roles.

Additionally, activist investors, once largely limited to the US, now have their sights set on the UK. Last year, there were 342 campaigns outside the US, compared with 70 in 2010. In the UK, FirstGroup, BHP Billiton and Premier Foods amongst many have all faced calls for a shakeup. However, despite the proliferation of activist investors there is still a sense that Boards are yet to take the threat seriously.

Either controversial or enlightened, Rolls-Royce was the first FTSE 100 company to give an activist, ValueAct, a seat on the Board. Whilst there is an element of 'bringing them into the tent' and it can work well as long as the agenda of the business and the investor coincide, it remains to be seen how this works when what is in the longterm best interests of the business departs from short term value creation.

Diverse Boards are stronger Boards

We continue to see a drive for diversity, both in terms of gender and race; and we fundamentally believe that diverse Boards are stronger Boards. The Parker Review, published in October 2017, reports that only 2 per cent of all FTSE 100 board directors are UK citizens of colour, while the current non-white population is 14 per cent and set to rise to 20 per cent by 2030. Only six non-white people currently hold the position of Chairman or Chief Executive, while 51 FTSE 100 companies did not have any non-white Board members. The report recommends that FTSE 100 companies should have at least one director from an ethnic minority background by 2021.

We support these recommendations, but believe that due to the complex and nuanced nature of racial representation, it is more difficult than with gender to define and standardise what best practise should look like across different businesses and sectors. For example in a business such as BHP Billiton (with a largely non-UK employee base), the basis and premise around racial representation is completely different to that of a UK grocer such as Morrisons.

As with gender, the lack of racial diversity on Boards reflects the historic lack of diversity in the executive ranks. Although greater diversity at Board level can help with role modelling, it will not by itself change things further down the organisation and the more important challenge is to continue to improve it at the executive level.

A nine-year limit

The proposed changes to the UK corporate governance code which will limit tenure strictly to nine years, no longer resetting the clock if a Non-Executive Director steps up to become Chairman, is a significant potential change scheduled for next year. It has merit as a way to help ensure independence and to mitigate accusations of a closed 'FTSE club'; nevertheless, it risks under-utilising individuals with authoritative credentials and valuable institutional knowledge. We will be monitoring this subject closely and will return to discuss it in our next newsletter, as the matter unfolds.

Renaissance directors

In our most recent research paper, MWM examines the reasons that the public company model is increasingly being challenged. Investors and other external stakeholders are questioning what the optimal governance structure should look like. Boards and executive teams, frustrated by the growing bureaucracy of public company governance and the short term focus on quarterly earnings, are attracted by the more focused nature of alternative ownership models such as private equity-backed businesses. Meanwhile, the expansion of alternative sources of finance, including cheap debt and the growth of sovereign wealth funds, make business less reliant on the equity markets.

We do not believe that the decline of the public company model is inevitable or indeed desirable; well run public companies are a fundamental part of the economy. But they need to rediscover their focus on creating long term value, both for investors and their broader stakeholders; they must recapture the 'owner's mind-set' with which they were originally created. Our report will make a number of recommendations aimed at helping Boards to reinvigorate the public company model.

Summary

Despite political and economic uncertainty, we continue to see the UK as a robust, flexible and adaptable business environment. Companies headquartered here, or with a listing in London, are in an environment which continues to reinvent and reframe itself against numerous challenges, despite the noise around issues like Brexit. The implication for both the executive and non-executive search market is that we anticipate continuing demand for high calibre individuals with London remaining a hub for international as well as UK talent for the foreseeable future.

MWM Consulting

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12 Charles II Street, London SW1Y 4QU
Tel: +44 (0)20 7484 1050