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Erasmus Platform for Sustainable Value Creation

Committed shareholders: A brief introduction

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Committed shareholders project

The Erasmus Platform for Sustainable Value Creation has initiated the Committed Shareholders Project with its partners. Shareholders are of great influence on companies. In the transition to a sustainable economy, companies and institutional investors are increasingly adopting the goal of long-term value creation, which integrates financial, social and environmental value. How can institutional investors, as committed shareholders, support sustainable companies and work jointly on the long-term agenda?

In a series of four research papers (see references below), we have investigated the facts and the dilemmas in the pursuit of long-term value creation. On the facts, we have produced a paper on institutional shareholdings in large Dutch companies and a paper on geographic exposures of these companies. On the dilemmas, we have conducted a survey to identify dilemmas for investors and companies and written a paper exploring pathways for long-term-alignment between investors and companies.

This brief introduction summarises the research findings and formulates two questions for discussion between institutional investors and large companies:

- Which model fosters i) selection of; ii) investment in; and iii) coordinated engagement with companies that pursue long-term value creation?
- Which mechanisms can strengthen commitment between institutional investors and companies on long-term strategy?

1. Introduction

Long-term value creation follows the ideology that rather than solely evaluating performance on the basis of financial outcomes, it also integrates social and environmental dimensions (Mayer, 2018; Edmans, 2020). A growing number of companies recognise the importance of transitioning to a sustainable economy and, therefore, adopt the goal of long-term value creation (Van Dam and Dijkstra, 2018; Schoenmaker and Schramade, 2019). Unfortunately, not all shareholders share this view or are unwilling to act in favour of long-term investments.

In a previous report in this series on committed shareholders, Tupitcyna (2018b) identified key barriers for Dutch institutional investors to refrain from long-term value creation. These barriers include benchmark orientation, short-term performance evaluation and incentivisation, lack of alignment within investment

chains, lack of integrated thinking, and lack of sustainability standards. In an additional report in this series, Schoenmaker and Carfi (2019) show that traditional investor paradigms have limited geographical clustering because investors feel that they need to be internationally diversified rather than invest locally.

In order to overcome these barriers and motivate institutional investors to become committed to their investee companies, a set of models is proposed. The goal is to find an appropriate model that enables management of companies to engage in long-term value creation with support and trust of its investors, while keeping market discipline of management. The role of investors (asset owners and asset managers) and companies in long-term value creation is enshrined in the Dutch corporate governance code and the Dutch stewardship code.

Hence the following two questions are formulated for discussion:

- Which model fosters i) selection of; ii) investment in; and iii) coordinated engagement with companies that pursue long-term value creation?
- Which mechanisms can strengthen commitment between institutional investors and companies on long-term strategy?

2. Conditions for long-term value creation

The concept of long-term value creation means that a company aims to optimise its financial, social and environmental value in the long term, preparing for the transition to a more sustainable economic model. However, current business practices are still too narrowly focused on short-term financial returns, meaning that we fail to achieve inclusive capitalism. For decades, maximising profits has been the leading objective in corporate finance. Nevertheless, companies have emerged that actively pursue long-term value creation.

What are the conditions for long-term value creation? We identify three key conditions for alignment between companies and investors on the long-term. First, companies need to report on long-term value creation to provide the necessary information to investors. That means that sustainability should be included in IFRS. Second, companies need a 'trusted' financial market with investors that are committed to their long-term strategy. Third, investors need to be able to sell their shares in case of structural underperformance or disagreement on the long-term strategy.

With long-term value creation in mind, investors buy stocks with a multi-year horizon (5+ years), both in terms of intended holding period and in terms of confidence in the sustainability of the business model. It is important to distinguish intended holding periods from observed holding periods. The latter may simply be a result of a very passive investment stance. An active investor could have a very long intended holding period but might still decide to terminate a position early

company (Edmans, 2017). While the option to sell ensures market discipline, the challenge is to work together on the long term. The next section discusses the models for cooperation.

3. The models

Nomination committee model

In the nomination committee model, currently present in the Swedish corporate governance system, the largest shareholders participate in a committee to select and recruit new board members for a specific company. The nomination committee also reviews annually the long-term strategy of the company with the CEO. This does not only require cooperation between the large shareholders, but also between management and shareholders as the (long-term) corporate strategy is discussed. Participation in these committees requires activism but also allows investors to influence corporate strategy and align preferences. A greater degree of influence on the company combined with a harmonised long-term strategy, may induce institutional investors to commit oneself to the company, while keeping market discipline.

Coordinated engagement model

Engagements, activism, exerting voice, all refer to same type of activity: investors encountering companies on a certain matter with the objective of altering company's course. Investors can engage on their own, being dependent on their own knowledge and their own shareholder power but can also engage in collaboration with other shareholders. The latter may give the consortium larger power (i.e. together they do have more shares), greater expertise (i.e. they can use each other's knowledge) and reduce costs and risks (i.e. costs and risks are shared among the participants) (Dimson, Karakaş and Li, 2015). Still, collective engagements face challenges, such as the free-riding problem and varying objectives of investors. However, an effective way to limit these issues and reap the benefits of collective engagements are coordinated engagements organised via an engagement platform (e.g. PRI collaborative platform or Eumedion). In this case, one or more lead activists organises the engagement. When the lead activists are from the same country as the target and possess large stakes in the company, the success rates increase. In the context of long-term value creation, such engagements should be on ESG matters and corporate strategy. Investing much time and efforts by investors in order to influence corporate ESG strategy suggests potential commitment to hold the company for a long period after a success engagement. Dimson, Karakaş and Li (2015) also find an increase of target shares by the lead investor(s) after a successful engagement, confirming their

commitment.

Privileged shareholder model

Companies often experience a diffuse ownership, having hundred if not thousands of different owners. These owners differ in type, size, objectives and commitment. However, large shareholder (blockholders), might have most power (although not having majority) and most interaction with company management. Considering the statement in The Purposeful Company Report (2017) that blockholders "are able to act as an anchor owner who lend stability to companies and their executives who are otherwise buffeted by short-term pressures", blockholders make potentially great long-term partners for companies. To create such long-term partners (i.e. incentivise companies to take large stakes), a privileged shareholder model is proposed, where long-term shareholders are provided with extra voting rights or dividends. Allowing companies to reward long-term investors could enhance long-term alignment between investors and companies. Nevertheless, the privileged shareholder model violates the proportionality principle, whereby voting rights or dividends are proportional to the size of the shareholding.

Assessment of the models

In a background paper (Houf and Schoenmaker, 2019), we provide a preliminary assessment of the models on various criteria. Dutch investors recognise six key challenges to long-term value creation and the models we proposed might overcome these (Tupitcyna, 2018b). We assess the appropriateness of each model on these challenges. Moreover, as we explore pathways to long-term value creation for Dutch companies, we also need to consider the feasibility and likelihood of success of each model under Dutch law and regulation. Hence, we added a seventh criteria: Dutch applicability.

Table 1 shows the evaluation matrix. The models are judged on a scale that ranges from --- to +++, where --- represents the worst score and +++ the best. A score of +/- indicates that we expect no noteworthy effect. The scores are briefly explained in the background paper (Houf and Schoenmaker, 2019) and are a starting point for discussion.

TABLE 1. ASSESSMENT OF MODELS

	Nomination committee	Coordinated engagement	Privileged shareholder
Overcoming benchmark orientation	++	+	+++
Defeat short-termism	++	+	++
Improvement of alignment in the investment chain	++	++	+++
Dialogue between investors and company	+++	+	++
Improvement of integrated thinking	+	++	+/-
Improvement of sustainability standards	+	+	+/-
Dutch applicability	+/-	++	-

4. Mechanisms

Committed shareholding, including engagement, is only meaningful and cost-effective when shareholders have a 'certain' stake in the company. Tupitcyna (2018a) investigates the institutional ownership of Dutch publicly listed companies. Table 2 indicates that the 10 largest institutional investors collectively own about 26% of the outstanding shares (based on the average figures). This gives them significant influence, but not predominant control (>30% of the voting shares). Among the ten largest shareholders of AEX companies feature the large asset managers, such as BlackRock, Vanguard, Fidelity and Norges Bank Investment Management.

Collectively, Dutch institutional investors own 2.1% of the outstanding shares. The two largest pension funds in the Netherlands, on average, hold 0.8% of the outstanding shares in large Dutch companies. These pension funds' Dutch shares

constitute about 1.5% of their total investments in equities and convertibles, which is close to the market capitalisation of Dutch companies in the world portfolio at 1.4%. Dutch institutional investors thus seem to follow international portfolio theory.

TABLE 2: INSTITUTIONAL OWNERSHIP OF AEX COMPANIES

Metric	Institutional ownership (as % of total outstanding)			
	Total institutional ownership	Number of large institutional shareholders (>3%)	Concentration of 10 largest institutional shareholders	Owned by Dutch institutional shareholders
Average	46.5%	3.3	26.4%	2.1%
Market weighted average	45.1%	2.8	24.1%	1.4%
Based on Author's Analysis, Thomson Reuters Eikon (Tupitcyna, 2018a)				

Follow-up research (Schoenmaker and Carfi, 2019) shows that investing in large Dutch companies does not automatically lead to an overexposure to the Dutch economy. Table 3 indicates that investing in a portfolio of large Dutch companies (listed on the AEX) leads to an exposure of only 10 per cent to the Dutch economy, 30 per cent to the rest of Europe, and 60 per cent to the rest of the world (based on market weighted average).

These findings on geographic exposures suggest that there is scope for Dutch institutional investors to expand their stakes in Dutch (and other European or international) companies that pursue long-term value creation, without unduly increasing their exposure to the Dutch economy.

TABLE 3: GEOGRAPHIC SEGMENTATION AEX COMPANIES

Metric	Revenue Segmentation (as % of total)		
	Netherlands	Rest of Europe	Rest of World
Average	20.6%	31.6%	47.9%
Market weighted average	10.6%	29.6%	59.9%
Based on Company reports, Author's Analysis (Schoenmaker and Carfi, 2019)			

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