SECTION 8: CAPITAL STRUCTURE AND ALLOCATION

Capital structure and allocation is the process of distributing a company's financial resources to enhance the firm's long-term financial stability and to protect its capital value. It can appear unexciting – and so often receives little attention from investors – but a misjudged approach to this can contribute to corporate collapse and failure.

Capital allocation practices include repayment of debt, repurchasing of shares, paying final or interim dividends to shareholders and investment either in organic growth or in mergers and acquisitions activity. There are several stakeholders whose interests need to be balanced in any capital allocation decision, including the Defined Benefit (DB) pension scheme, shareholders, employers and customers. In addition, the appropriate ratios between profitability and dividend payments must be maintained.

Although some of the issues highlighted may seem technical or of low priority, investors should be alert to signs that the company continues to fail to honour shareholder rights. In 2016, BHS went into administration[92] following several corporate governance failures including the payment of illegal dividends. The total dividends paid by BHS Ltd between 2002 and 2004 were £414 million, almost double the after-tax profits of the company of £208 million.[93] For its part, Carillion paid out £376m over a five-year time period while generating £159m of net cash from operations.[94] Carillion also paid an interim and final dividend every year from 2010.

In recent years, there has been a significant increase in the number and proportion of initial public offerings (IPOs) that have dual-class share structures.[95] According to the Investor Coalition for Equal Votes, these structures – where a company has two or more share classes, and these differ in terms of voting rights – dilute the ability of minority shareholders to effectively hold companies to account.

The growth in the prevalence of dual-class share structures and the potential loosening of regulatory requirements around the use of dual-class shares raises important questions for investors concerned about the integrity and operation of capital markets.[96]

[92] Murad Ahmed 'BHS goes into administration after sale talks fail', Financial Times (2016) <https://www.ft.com/content/3f83c690-0aad-11e6-b0f1-61f222853ff3>.

[93] Work and Pensions and Business, Innovation and Skills Committees 'BHS', Work and Pensions and Business, Innovation and Skills Committees (2006) <https://publications.parliament.uk/pa/cm201617/cmselect/cmworpen/54/54.pdf>.

[94] Federico Mor, Lorraine Conway, Djuna Thurley, Lorna Booth 'The collapse of Carillion', House of Commons Library (2018) <https://researchbriefings.files.parliament.uk/documents/CBP-8206/CBP-8206.pdf>.

[95] Ritter, J. 'Initial Public Offerings: Dual Class Structure of IPOs Through 2023', Warrington College of Business (2024) <https://site.warrington.ufl.edu/ritter/files/IPOs-Dual-Class.pdf>.

[96] Investor Coalition for Equal Votes 'Undermining the Shareholder Voice: The rise and risks of unequal voting rights', Investor Coalition for Equal Votes (2023) <https://cdn-suk-railpencom-live-001.azureedge.net/media/media/pmcil2eb/icev-report-2023-undermining-the-shareholder-voice.pdf>.

In their latest consultation on proposals for UK listings reforms, the FCA propose a more flexible approach to DCSS and do not intend to introduce any time-related sunset requirement to limit the exercisability of enhanced voting rights.

DIVIDENDS

Information on dividend structure, including both policy and practice, will be of interest both to equity investors who are looking for income or growth potential, and bond investors who are considering a company's long-term creditworthiness.

NEW SHARES

In company law, companies must secure shareholder approval to be able to issue new shares. Resolutions that allow the company to issue new shares are normally of two types: 'Section 551'[97] and 'Section 570'[98] Authorities.

Resolution types: Issuance of new shares

- *Section 551 Authorities* allow companies to allot new shares. Any amount in excess of one-third of existing issued shares should only be applied to fully pre-emptive rights issued in order to protect against shareholder dilution.
- *Section 570 Authorities* allow companies to issue shares for cash without the application of pre-emption rights. The Pre-Emption Principles are equivalent to 10% of the issued share capital at the time of the authority. An additional 10% is acceptable provided that the company confirms in its AGM that it intends to use this only in connection with an acquisition or specific capital investment – which is announced at the same time as the issue – or which has taken place in the preceding six-month period. A multi-year limit also applies to the issuance of shares for cash in connection with an acquisition of a specific capital investment (typically a maximum of 7.5% shares to be issued over three years without the application of pre-emption rights).

SHARE BUYBACKS

Takeover Code Rule 9[99] waivers are usually sought when a company proposes to institute a share buyback programme in which a large investor or concert party intends not to participate. This brings with it the risk of creeping control – which is a clear issue of concern to shareholders.

[97] Companies Act 2006, The Stationery Office <https://www.legislation.gov.uk/ukpga/2006/46/section/551>.
[98] Companies Act 2006, The Stationery Office <https://www.legislation.gov.uk/ukpga/2006/46/section/570>.
[99] The Panel on Takeovers and Mergers 'The Takeover Code' Thirtheen Edition, The Panel on Takeovers and Mergers (2021) < The-Take-Over_Bookmarked_20.2.23.1.pdf (thetakeoverpanel.org.uk)>.

Resolutions on dividends, share buybacks or issuance and debt constraints in articles need to be set within a considered capital structure framework. This framework should balance the need for shareholder returns with the long-term viability of the business.

EVIDENCE BASE

Dividend information can be found in several different corporate communications, including the Annual Report, interim accounts, press releases and preliminary announcements. It should be noted that companies often fail to clearly articulate the story of the dividend, from policy development – including the rationale for its approach – to declaration and payment. Although there should also be a justifying statement around the dividend, this does not always happen.

The viability statement should also provide a basis for an annual assessment and debate on capital structure. However, these rarely provide as much useful and high-quality information as they could – it is notable that the Brydon Review recommended the production of a Resilience Statement to perform a similar function.

Key metrics for investors to pay attention should include the “payout ratio,” where dividends are set as a percentage of a defined metric (this could be earnings or free cash flow). Where this is used – and particularly when the ratio is not based on a defined IFRS metric such as earnings of cashflow – the rationale for the selection of metrics should be justified.

The Annual Report should disclose related party transactions which are significant, whether by virtue of their significance to the business, the individuals involved or the perception of potential conflicts.

WHAT DOES GOOD COMPANY BEHAVIOUR LOOK LIKE?

- Companies take capital structure decisions which balance the financing needs of the firm with the interests of broader stakeholders. This includes striking the right balance between dividend payments to shareholders and paying Deficit Repair Contributions (DRCs) to any DB pension scheme. In addition, this includes undertaking share buybacks only when doing so is the best way of achieving long-term value. Dividend resolutions should not simply be approved as a matter of course and moves that weaken a company’s balance sheet – and so its long-term stability – are not in the long-term interest of the shareholder.
- Companies should adopt single-class share structures at IPO or as soon as possible thereafter. For any dual-class share structures where sunset clauses are not adopted, companies should adopt provisions that require periodic approval, at least every seven years, from a majority of each share class voting separately, for the dual-class share structure to continue, and adopt supplemental safeguards for pivotal proposals.

Dividends

- Companies have clear dividend policies. These should set out the circumstances for distributing dividends and returning capital to shareholders. There should be evidence that the financial position (especially distributable reserves), maturity and strategy of the business – including the necessary level of DRC to any DB scheme – have been appropriately considered and reflected. Investors should pay attention to the possibility of companies taking on more leverage to cover dividends to shareholders.
- Dividend policy disclosure is specific. The information given should be at a sufficiently granular level so that investors can understand what the policy means in practice, including the basis for deriving the proposed level of dividend and the specifics of how it is determined. It should describe the governance process over the policy decision, the risks and constraints associated with the policy and the timeframe over which the policy is expected to operate.
- There is a prudent level of interim dividends issued. Such dividends are usually decided solely by Directors without the need for shareholder approval. There is a growing trend for companies to pay only interim dividends, which is detrimental to the role of investor oversight on this issue. Where a scrip dividend or equivalent is issued, there should be a cash dividend also available.
- Shareholder approval is sought for the approval of the financial dividend. Should this not be the case, investors should strongly consider submitting a shareholder resolution or voting against the company's Report and Accounts, except where companies can compellingly demonstrate that changing their practice to seek shareholder approval of the dividend would significantly delay payment and materially disadvantage shareholders.

Share buyback

- There is a clear rationale – one that aligns with the interests of long-term shareholders – for any share buybacks undertaken. Share buybacks can, on occasion, be a useful tool for companies to manage their capital structure and most investors will support these repurchases, provided local market regulations and relevant shareholder guidance are met. However, share buybacks can be manipulated by managers whose pay is aligned with earnings per share, in a way which comes at the expense of long-term investors or the company's long-term success. Metrics and disclosure provided should cover:
    - The weighted average cost of shares bought
    - Total cost
    - Impact on key metrics for buybacks undertaken during the previous year
    - Clear explanation of the process used to identify when buyback is appropriate
    - The maximum price the company is willing to pay and the hurdle rate in respect to the buyback, linking to the overall capital management framework of the company.

Issuance of new shares

- The company recognises that pre-emption rights are important for the protection of stakeholder interests. Companies should seek to abide by the recommendations of the Pre-Emption Group UK Statement of Principles[100], except where they can make a clear case for these not being applied in the context of the best interest of the owners of the company concerned. To protect the rights of existing shareholders and reinforce the accountability of management to the company's owners, companies should avoid the creation of "poison pill" provisions except in exceptional circumstances.
- Any non-pre-emptive issue is clearly signalled at the earliest opportunity. Companies should also seek to establish a dialogue with investors at this stage. They must keep shareholders informed of issues related to an application to disapply their pre-emption rights. The Pre-Emption Group Principles should be followed.
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Related Party Transactions

- There is a robust and independent process for reviewing, approving and monitoring related party transactions (RPTs). This should include both individual transactions and in aggregate, as well as appropriate procedures to identify and manage conflicts of interest.
- There is a Committee of Independent Directors with the ability to take independent advice that reviews significant RPTs and the board confirms that all RPTs have been reviewed and met with its approval. The Committee's review should include aggregate levels of RPTs to determine whether they are necessary, appropriate and in the best interests of the company and shareholders.

HOW INVESTORS SHOULD CONSIDER VOTING

There are several different resolutions pertinent to various capital allocation issues, including approval of final dividend, issuance of new shares, market purchase of shares, and related party transactions.

Investors should consider voting against approval of the final dividend if:

- The dividend does not seem sustainable and appropriate, when considered in the context of the financial position, maturity and business strategy, or where issues such as DRC are not appropriately reflected.
- There is no cash dividend available as an option to a scrip dividend or equivalent.
- They have concerns regarding the accounting standards and assumptions used in the metrics provided.

[100] Financial Reporting Council 'Pre-Emption Group Statement of Principles', Financial Reporting Council (2022) <PEG_Statement-of-Principles.pdf (frc.org.uk)>.

<u>Investors should consider voting against a resolution on issuance of new shares</u> if:

- Section 551 and Section 570 Resolutions are bundled together. The issuance is not consistent with Pre-Emption Principles without a satisfactory explanation.

<u>Investors should consider voting against a resolution on market purchase of shares</u> if:

- The resolution proposes a waiver of Rule 9 of the Takeover Code.
- The buyback is not deemed a prudent use of the company's cash resources, is not supported by cash flows of the underlying business and introduces excessive and unsustainable leverage.

<u>Investors should consider voting against a resolution on related party transactions</u> if:

- An RPT has not been subject to proper oversight by the board and regular review (through the audit or shareholder approval).
- The RPT is not: clearly justified or beneficial to the company; undertaken in the normal course of business; on fully commercial terms; in line with best practice; or in the interests of all stakeholders.

It is important to caveat that within the FCA's consultation CP23/31 published in December 2023 where detailed proposals for UK listings reforms have been outlined, the proposed approach to the inclusion of a related-party transaction remains a disclosure-based regime. The FCA are not proposing requiring a shareholder vote in their latest consultation.[101]

<u>Investors should consider voting against a resolution on re-election of the Chair</u> if:

- There is an unsustainable level of interim dividends issued and they have reason to believe that this is being done to avoid shareholder scrutiny. Please note that this is a serious issue and if investors have concerns in this space, they could accompany this with a vote against the Annual Report and Accounts.
- Shares are issued outside of the Pre-Emption Group Principles.

Investors should consider voting against the Governance Committee Chair (or equivalent) if:

- Company has a dual class share structure without a sunset clause of seven years or less from the date of the IPO.

[101] Financial Conduct Authority 'CP23/31: Primary Markets Effectiveness Review: Feedback to CP23/10 and detailed proposals for listing rules reforms', Financial Conduct Authority (2023) <https://www.fca.org.uk/publication/consultation/cp23-31.pdf>.