The Future of Boards and The Board of the Future

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We would like to thank Partners Group for supporting this Student Project.

AGENDA

1. Motivation

The motivation of this project is to develop a perspective on the trends affecting company board governance (the "Future of Boards"). Specifically, through a series of interviews with board directors we sought to analyze how trends such as diversity, remote work, ESG, amongst other items, are affecting and shaping boards, with a focus on differences between public and private boards. Based on these analyses we also seek to identify what the Board of the Future should look like in terms of operating model, use of technology, and impact of ESG on its function.

2. Approach

The research paper focused on getting insights from current or former board members of companies, gathered through primary interviews. The focus was on those who have experience in private companies to see if there is a secret sauce that drives better alpha (excess returns) in private versus public companies. This was also supplemented with secondary research information available for public and private companies. Overall, 12 directors from various industries were interviewed. The interview guide is included as an appendix.

To complement the interviews, a dataset of information on board members was extracted from S&P Market Intelligence platform. The search excluded companies with less than 3 listed board members yielding a total of approximately 150,000 companies globally. Details were then extracted for a sample of about 30,000 of these companies (see Appendix, Table 1) to include the following information on each of the listed board members: board member name, approximate age, year the appointment began and ended, other boards that the individual sits on and educational details. The sample selected companies is representative of a variety of industries and countries across the world.

3. Results – Trends Affecting the Future of Boards

A. Growing Board Responsibility

In our interviews we noted an increase in board responsibility particularly in the areas of ESG, diversity, agenda and board involvement with management.

i. ESG

a. <u>Requirements have increased</u>. For public boards this has become a significant issue. Several directors hypothesized that as liabilities have become more onerous for public board directors it is becoming increasingly difficult to get directors to sign up to be a public board director. Conversely, it makes it more attractive for good talent to sign up for the private boards.

b. <u>Non-targeted response for public boards</u>. Interviewees were of the view that for public boards, ESG is a 'tick the box exercise' and the elements of ESG that are critical to the business (e.g., health and safety of employees or customers) can be subsumed by ones which may not be so important (e.g., environment).

Conversely, for private boards they can spend time on the elements which are truly important to the business or the shareholder.

c. Private companies publicizing their efforts. For some directors on the boards of family operated companies there was a view that 'sustainability' was already part of their ethos but that in the past the family had chosen not to publicize this. However, with increasing expectation that companies behave as good corporate entities they are putting more effort into publicizing their efforts.

d. Get the balance right. Most directors felt it was important to get the board balance right. For instance, one director said "[ESG] can't be the dominant topic of conversation, and it is not a productive use of time in all cases", it should be covered in board papers, taken as read and commented on if required. ESG should be important but not a core component.

For some directors, the G (Governance) in ESG is important and critical to the role of the business. It is something companies have to do and forms part of good strategy. E (Environment) for most interviewed was of low importance but S (Social) and looking after employees and the communities they operate in was critical.

e. Public versus private company divergence. Directors agreed that ESG requirements were more rigorous in public boards. One director stated that the focus on ESG will lead to having less qualified people joining public board, which could filter through to worse outcomes for companies. In Australia, one director stated, "I am hoping that we get some sanity in the public environment where we choose the best person for the role [and not just the old boys club] and make it less regulatory for them [in terms of penalties], if it moves that way I'll be happy otherwise you won't get good directors on public boards and the performance will drop; in the private sector I can see them getting bigger and bigger they know how to add value and make the right decisions in terms of structure and value and decision making, because they have access to capital as well."

Another Asia-Pacific based director stated, "We have not seen the need to devote time to [ESG] and we do have a better balance of our time. For us the most important aspect of ESG for the private group is safety because that is what our customers judge us by; also, we see good safety as good management, but we don't dial up the environmental, and for a business this size this is appropriate".

ii. Diversity

Most directors agreed on the importance of diversity, but there seemed to be more interest in the younger directors (<50) than ones aged (65+). For the elder directors one highlighted that diversity in terms of experience and age, particularly for digital topics, was becoming more and more important. For another director diversity in terms of not just having lawyers and accountants but people with operating experience was critical. Directors were also in favor of gender diversity although there was no consensus over the need for quotas.

Younger directors were more enthusiastic on the importance of diversity. One director stated that "when it comes to diversity, I think it is a genuinely positive change, diversity of industry and background brings broader experience to strategy. The last thing that you want are people who reflexively support management - you want the opposite. So, the more diverse they are the more likely they are to come up with a different view". For another, "I see diversity as an amazing thing, but adding something for the sake of ticking a box is inappropriate, you need to attract the right people with the right understanding."

iii. Agenda and Board Papers

A common theme among directors was the lengthening of agendas and how a change would be needed in this aspect. Some board members mentioned that more proactivity and input for each member is needed and that management presentations will decrease in importance. One director anecdotally stated that in 2010, 75% of time was spent on management updates versus 30% now.

Other directors have also taken the view that there is an element of too much information being prepared in board papers, essentially data dumps of 200-230 pages. So, to make sure that the board meeting is streamlined there needs to be discipline in the data being prepared for and by management.

iv. Board Involvement with Management

All directors mentioned an increase in the requirement to be involved with management. With one company this was each director taking care of a particular area, for another company this was the directors participating in calls, for another this was talking to a CEO's direct reports on a regular basis or giving employees time with him to learn more about the business. Therefore, at least for the directors of companies interviewed there may be more of expectation for directors to proactively add value rather than being passive approvers of management's strategy.

B. New Ways of Working

i. Digitalisation

Throughout the past year, digitalisation has taken a step-change. In the US for example, the penetration of e-commerce grew as much in the first three months of COVID-19 as in the past 10 years[1]. There is no doubt that organisations have also had to adapt and change their ways of working and boards are no different. The recent pandemic has questioned the need to hold offsite in-person board gatherings to discuss a multitude of issues, but instead boards have had to hold more frequent and shorter online meetings to provide a fast resolution turnaround. This new collaboration model has been welcomed by many, who believe that several of these changes are here to stay. One of the likely outcomes of ongoing online and remote collaboration is a reduction in the travel load and thus enabling board members to participate on numerous boards. This is supported by the directors interviewed, for instance one director noted that during COVID the board met twice a week, digitally to discuss issues; another director stated that with the familiarity of digital tools there was more scope for directors to dial into more management meetings, and that he expected there to be less pressure to meet so frequently in person.

Figure 1 below shows that for many regions across the world, board members are participating in an increasing number of companies, particularly in the US and Canada, where on average each person participates on almost 2 boards. Interestingly, while the increasing trend is maintained for public companies, for private companies this trend appears to have reversed around 2014, perhaps indicating increasing pressure for private company boards to focus on an individual assignments.

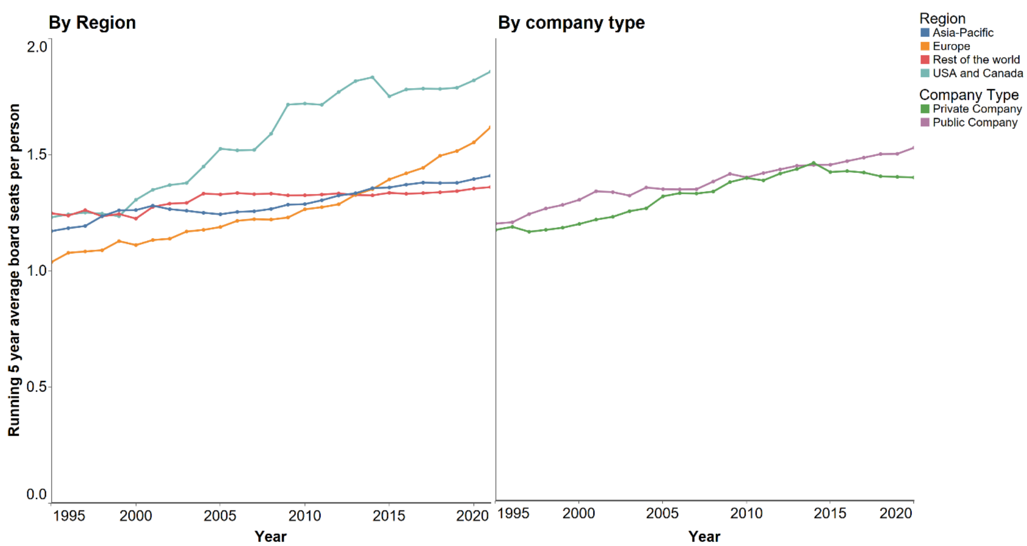
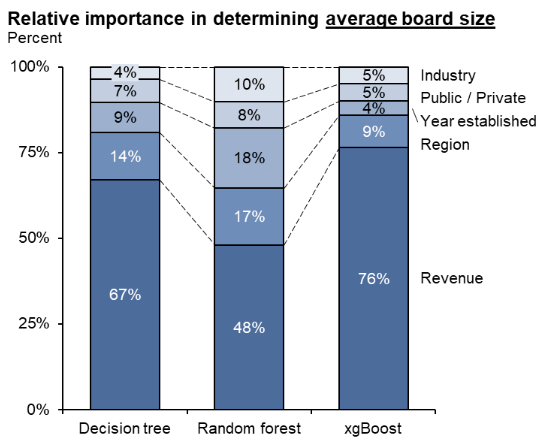


Figure 1 – running 5-year average number of boards that a board member is part of by region between 1995 and 2020. (Sample size *n* = 29,424)

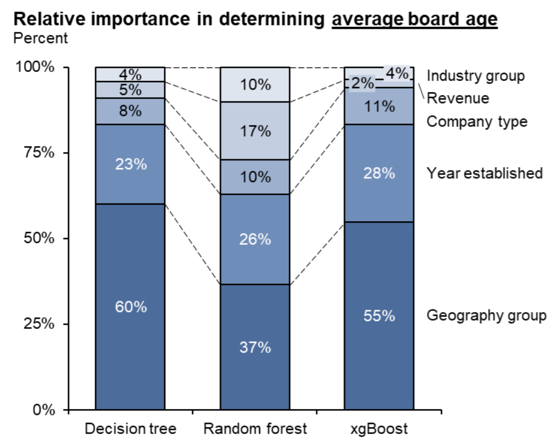
[1] McKinsey Quarterly – The quickening

ii. Board Structure

Board size and the average age of its constituents were two measures that were extracted from S&P Market intelligence and studied against company characteristics including revenue, primary industry classification, geographical region, company type (public or private) and year of establishment. Machine learning regression and classification technique were then employed to understand which company characteristics were the best predictors for the size of the board and its average age as shown in Figure 2. Overall, these characteristics performed poorly at predicting either measures with typical R-squared values in the range between 0.2 and 0.3 suggesting that there are likely to be many other factors that influence the size and average age of the board. Nevertheless, the model did reveal some insights regarding the relative importance of the factors studied – revenue and geographic region were the best predictors of board size whilst geography and year of establishment were the most influential in determining the average age of the board. Perhaps unsurprisingly, companies with higher revenue tend to have larger boards whilst newer companies tend to have younger board members.



Model R^2	0.30	0.29	n/a



Model R^2	0.21	0.21	n/a

Figure 2 – relative importance of factors in explaining the average board size and age, the larger the percentage the more relevant a metric is in explaining the variance

These observations were generally aligned with the responses from board directors, with those on public companies mentioning the larger size versus private companies. In terms of size, opinions varied but the numbers varied between 6-12 members. In terms of demographics many directors saw it likely to involve younger people in the boards in some way, either directly or through the use of ‘shadow’ or advisory boards. Therefore, it is possible that this type of board could become a way to include younger people in the strategic direction of the company. However, one interviewee mentioned that it was not essential to have a digitally enabled person on his board, but rather to have that person sit within the management team.

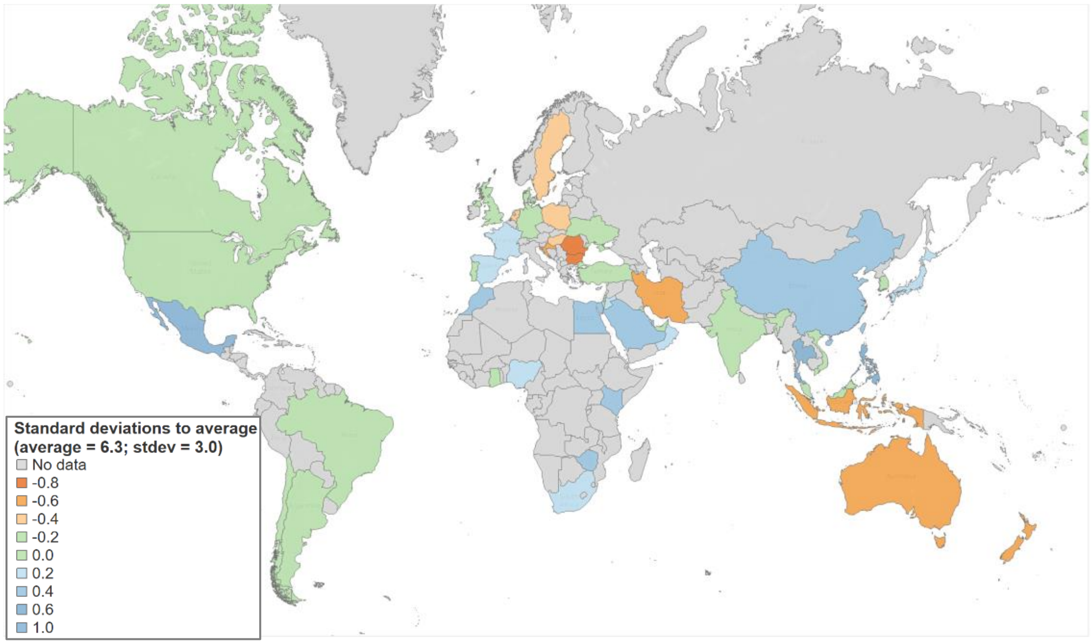


Figure 3 – map showing average board size by country relative to the world average. (Sample size *n* = 29,158)

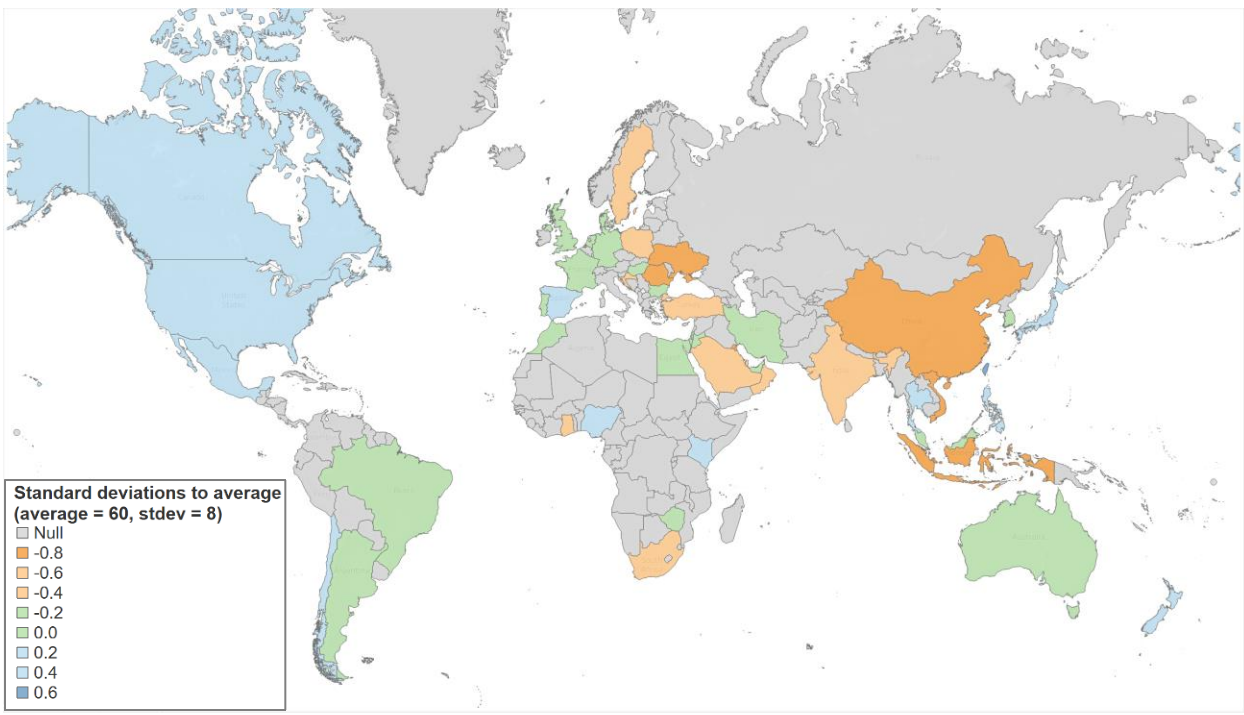


Figure 4 - map showing average board age by country relative to the world average. (Sample size *n* = 21,725)

The geographical differences in board size and age show in Figure 3 and Figure 4 is more interesting to observe. Boards from Eastern Europe and Oceania were smaller in size while China has larger boards, perhaps reflecting China's consensus building leadership culture. In terms of age, it can be observed that Asia generally has younger boards that average 50-55 years of age, whilst the North America tend to have older boards averaging 60-65 years. These differences are partially related to the degree of socio-economic development – in China for instance, the statutory retirement age is 60 years for men and 55 for women thus resulting in younger boards on average.

One final dimension studied in this report are trends on the board's educational level. Figure 5 shows how the share of the highest attained educational level for board members has changed since 1990. In the last 15 years, master's degrees have gained popularity against bachelors and doctorates. Since 2005, the proportion of board members with a master's degree has gained 10 percentage points against other educational levels. This reflects the increasing popularity and value of MBA-style programs in accelerating and building a career in management.

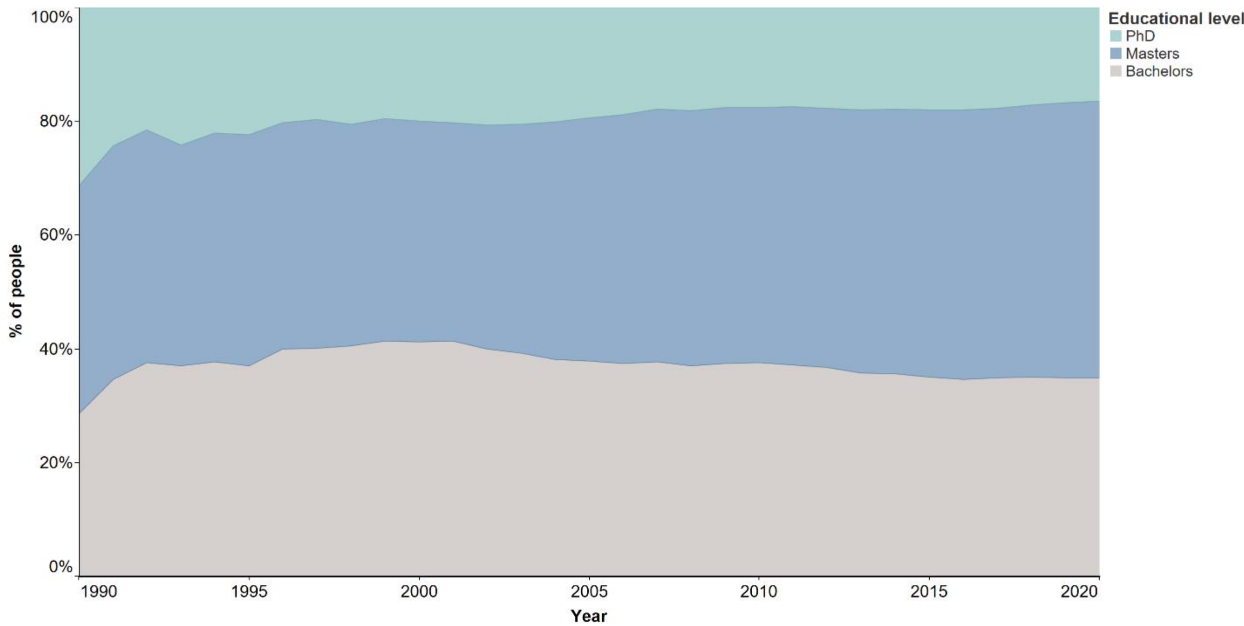


Figure 5 - running 5-year average share of highest attained educational level for board members between 1990 and 2020. (Sample size *n* = 38,605)

iii. Board Performance Assessment

Interviewees have unanimously agreed that performance assessment of a board is challenging for several reasons. First, it is difficult to assess the value addition of a board to the performance of the company. Second, most performance assessment is only conducted in an ex-post basis after some severe events that destroy part of company's value. Third, criteria used in the performance assessment vary greatly from board to board.

Having said that, some interviewees believe that board performance assessment would become more standardized as certain governance bodies (such as Canadian Coalition for Good Governance) work to converge measurements into a central framework, allowing at least some companies, if not all, in the same geographies to benchmark against each other.

Some interviewees also brought up the idea that high technology such as AI and machine learning may play a role in board performance assessment in the future. Algorithms would analyze historical data and run models that help predict the performance of a certain board, then benchmark against the actual performance of a company. The challenge here remains understanding the data one collects from a given board, particularly the correlation among different variables and the legality of a model given the possible biases existed.

iv. Board's Responsibilities Now and in the Future

Most views from interviewees rest on extrapolation of current trends. These include board's role to advise management when consulted, to discuss high-level business strategies in sub-committees, to identify industry trends such as ESG and advise on implementation.

While company boards lie on the spectrum between active and passive boards, some interviewees suggest that going forward, existing companies may diverge towards the binary sides. For example, a well-functioned board may have more incentives and motivation to become more involved given the accomplishment, inducing a self-reinforcing loop to push the board to the active side. The opposite may be true. Therefore, having new members to sit on the board from time to time is crucial to a balanced board.

Another interviewee shared that as opposed to inward-looking, boards in the future would gradually involve more members to look outside the company and focus on the impact of externalities. This is because companies today face disruptions from external forces more than ever, and these include changes in government regulations and policies, stakeholder activisms, climate changes and environmental degradations, and social unrests. Companies such as Sanofi have already constructed an external board composed of industry experts to provide perspectives on these fronts.

4. Results – The Board of the Future

Figure 6 - key themes for the board of the future by board composition and meeting regiment.

5. Conclusion

Companies are experiencing major disruptions thorough societal changes, technology and accelerating market dynamics, increasing the complexity of making informed management decisions. As a result, the board of directors' deal with a higher uncertainty with the need to act as steward for management and quickly respond to business needs. They also need to engage and be proactive around the areas of ESG, diversity and general management.

Boards also increasingly shift their focus away from a "shareholder-only" approach to an "integrated" approach covering all stakeholders (e.g. employees, customers, communities, regulators). The shift in the agenda of the board can be seen in the increase in frequency of board meetings and the set-up of expert committees to support board's decision making. As the agenda of the board is changing, the required skillsets for individual board members are shifting as well. Boards are increasingly transforming themselves to increase diversity in order to be capable of responding to business needs with experience and diverse viewpoints. This trend is expected to continue in the future. We will see more diverse boards not just in terms of gender ratio, but also with regard to age, industry experience, educational, and cultural background. Boards will have to get more agile and will use technology to support efficient conferencing, sharing of confidential information and just in time updates of business performance.

Today, boards are under pressure to transform themselves for the future. But how effective are the boards and will the boards be going forward to support their transformation to a more diverse and agile, yet impactful committee? How can the board performance and response to change objectively and accurately be measured? How could the action plan for effective board transformation look like for a portfolio company of Partners Group?

These questions could be addressed in future project initiatives:

a. Board performance and transformation. As a first step, it would be interesting to critically review current processes and evaluation criteria that are being used to assess board performance. Building on that, future projects could create an evaluation model for board effectiveness and performance by including dimensions such as response to change or transformation effectiveness. Board performance in general seems to be measured rather subjectively by the board and investors themselves, yet it would be interesting to see whether board performance can be benchmarked within an industry. Future initiatives could include this topic and create a model to assess and benchmark board performance that enables to draw inferences on best practices within a particular industry.

b. Action plan for companies. Shedding light on the current trends that affect the board of directors and impact the set-up of the board of the future was the focus of our analysis. A future project initiative could build on our findings and propose a concrete action plan with timeline for an effective board transformation with focus on a particular portfolio company or industry. In general, a blueprint for board transformation could be developed. If a collaboration with a company is possible, a future initiative could collaborate with its board and support in creating a vision for its board of the future and a transformation schedule on how the underlying board can respond to its challenges and the new trends.

Appendix:

Interview guide

Subject: Future of Board and Board of the Future

Date: 25/03/2021

This document is intended as a guide to support discussions with expert interviewees. The discussion with the expert will be broadly structured by the themes outlined in this document, with the interviewer tailoring areas covered by the expertise of the interviewee.

<u>Interview guide</u>

The bold questions are the key ones to explore, bullets are prompts to help guide the conversation

Introduction:

- Brief overview of the project and structure of the interview

e.g. - "Hi, we are currently working on an INSEAD project trying to understand the trends that will have the greatest impact on how boards of the future will operate and be structured. We wanted to spend some time with you to discuss your experiences on the boards that you've been on or observed and get your views on how the role of the board has changed and will change in the future. Finally, we would also like to get your views on what are the characteristics that make a board from being good to excellent."

- Brief overview of expert's current role, experience and areas of expertise

How has the role of boards changed in the last decade?

- What are the key trends that have shaped boards to be what they are today?
- Are boards today more or less effective than before?
- Are there specific industry / geographic nuances – i.e., boards of certain countries / industries have changed?
    - Why those countries / industries specifically?

How do you envision boards in 10 years' time would look like?

- How do you see the role of the board changing over the next 10 years?
- What are the key trends / drivers for these changes?
- Would boards still be relevant in the future given how much data and information management has to make informed decisions?

[For warm intro/targeted interviews] Are there any key lessons learned from your time on the board of [x]?

- What are the things that could have been done differently?
- If you could change one thing from that experience what would it have been and why?

What are the characteristics of an excellent board?

- How do you measure board performance?
- What are the characteristics that matter?
  - Size of the board – how many members?
  - How many members of management should sit on the board (e.g., Europe multiple; Anglo-American: CEO only)?
  - Diversity – ethnic, gender, socio-economic, age
  - Relevant experience vs industry diversity
  - Educational level
  - Personality traits and group cohesion
  - What is the maximum number of boards a person should sit on?
- What is the effect of tenure and rotation? *[Hypothesis: if someone on board too long they become inward looking and lose independence; on the other hand, if one rotates a director too soon then you lose the value of their contribution]*
- How do you spend time? What is your role as a board director?
- If you had to allocate 100 points, how would you allocate it across these different activities (i) today and (ii) in an idea tomorrow?
  - Strategy
  - Investment Decisions
  - People (e.g., coaching)
  - ESG (Environmental, Social, Corporate Governance) / Sustainability
  - Risk
  - Compensation
  - Other

Close-out:

Are there any closing thoughts about the future of boards / important topics we didn't get time to touch on today?

Table 1 – Number of companies by industry and region extracted from S&P Market Intelligence

	Total = 29,424	*Consumer*	*Energy / Utilities*	*Financials*	*Healthcare*	*Industrials*	*Materials*	*Real Estate*	*TMT*
Region	*USA*	350	349	299	350	350	350	350	350
	Canada	324	350	350	350	299	348	188	349
	Developed Europe	350	272	349	350	350	275	350	349
	Developing Europe	350	184	335	142	350	226	162	289
	UK	338	275	337	274	332	262	273	344
	LatAm	330	223	275	40	272	167	96	142
	Middle East and Africa	350	275	349	275	350	350	313	332
	China	350	261	316	274	350	302	260	350
	India	349	275	349	349	350	350	334	350
	Australia / New Zealand	350	289	302	301	285	348	213	350
	Developed APAC	323	210	320	334	300	331	239	327
	Developing APAC	374	383	375	209	397	366	397	369