

# Assessing Management and Understanding the Proxy Statement

BEN CLAREMON  
COVE STREET CAPITAL

JUNE 2019





# Safe Harbor

- The opinions expressed herein are those of Cove Street Capital, LLC and are subject to change without notice. Past performance is not a guarantee or indicator of future results. Consider the investment objectives, risks and expenses before investing.
- The information in this presentation should not be considered as a recommendation to buy or sell any particular security and should not be considered as investment advice of any kind. You should not assume that the security discussed in this report is or will be profitable, or references we make in the future will be profitable or equal the performance of the security discussed in this presentation. The report is based on data obtained from sources believed to be reliable but is not guaranteed as being accurate and does not purport to be a complete summary of the available data.
- Cove Street Capital, LLC is a registered investment adviser. More information about us is located in our ADV Part 2, which is on our website or upon request;  
<http://covestreetcapital.com/faq/>



# Cove Street Capital...at a glance

- Cove Street Capital ("CSC") is an LA-based, SEC-registered investment adviser founded in 2011
  - 100% employee owned
  - ~\$1 billion under management
- Concentrated, Small/SMID Cap value focus
  - Business, Value, People
- Talent-dense analytical team
  - Jeff Bronchick, CFA
  - Eugene Robin, CFA
  - Ben Claremon
    - Principal and Portfolio Manager
  - Dean Pagonis
    - Principal and Research Analyst
  - Andrew Leaf
    - Research Analyst
- <http://covestreetcapital.com/>



# Presenter Biographies

## ► Ben Claremon

Ben Claremon joined Cove Street in 2011 as a research analyst. He also serves as a Co-Portfolio Manager for our Classic Value | Small Cap Plus strategy. Previously he worked as an equity analyst on both the long and the short side for hedge funds Blue Ram Capital and Right Wall Capital in New York, and interned at West Coast Asset Management in Santa Barbara. Prior to that, he spent four years with a family commercial real estate finance and management business. Mr. Claremon was also the proprietor of the value investing blog, The Inoculated Investor. His background includes an MBA from the UCLA Anderson School of Management and a BS in Economics from the University of Pennsylvania's Wharton School.

## ► Dean Pagonis

Dean Pagonis joined Cove Street in 2014. During business school in 2013, he consulted on distressed assets for the private equity firm Origami Capital, after winning their \$50,000 international prize for investment ideas. Prior to business school, Mr. Pagonis was an analyst at the asset management firm Fort Point Capital Partners in San Francisco. He began his career as an analyst at the Abraxas Corporation, where he provided research for the US defense community and fund managers. Mr. Pagonis received his MBA at the UCLA Anderson School of Management and earned his BA in International Studies from American University with Phi Beta Kappa honors.

## ► Andrew Leaf

Andrew Leaf joined Cove Street in 2018 as an Associate from Sagard Holdings, a multi-strategy fund where he performed fundamental due diligence and valuation analysis in assessing small-cap companies. Prior to this role, Mr. Leaf was an Analyst in the Mergers & Acquisitions group at Deutsche Bank, working on buy-side, sell-side and strategic alternative transactions. He graduated magna cum laude from Georgetown University's McDonough School of Business with a degree in Finance and Accounting.



# Investment Philosophy

- Classic fundamental, research-driven value investing
- Concentrate on best ideas
- Think and act long-term
  - Mathematics of compounding
  - Less is more
- Key investment questions:
  - Is this a high return company that is getting more valuable each day?
  - Is this company run by honest people who understand capital allocation?
  - Is the stock undervalued based on conservative assumptions about the future?



# 4-Step Investment Process

- Generating Ideas
  - Screen for both good businesses & cheap stocks
  - Screen for behavioral anomalies/companies in transition
  - Collective investment experience/contact network/out of office experiences/management meetings
- Qualify
  - CSC Capital IQ-linked analytic spreadsheet
  - Company quality
    - Buffett stock—good business at a reasonable price?
    - Graham stock—cheap security that provides a large enough margin of safety?



# 4-Step Investment Process (cont.)

- Deep dive
  - Team tackle by generalists: 2 long, 1 short
  - Triangulate intrinsic value
    - DCF, SOTP, multiples analysis
    - Sustainable competitive advantage?
  - PEST analysis—Political, economic, social, technological risks
- Decision
  - Full or half position?
  - Margin of safety
  - Sufficient risk-adjusted upside
  - Establish sell discipline

# Reading/Viewing Materials Provided

8

- ▶ SNBR Proxy
- ▶ SKX Proxy
- ▶ Interview with Ben Claremon:  
<https://www.youtube.com/watch?v=lirBiAUyhU>



# Topics to Cover

9

- ▶ Who manages the company really matters
- ▶ Why capital allocation is so important
- ▶ Framework for assessing company management
- ▶ The purpose of the proxy statement
- ▶ Important proxy contents
- ▶ Company case studies (SKX and SNBR)
  - ▶ Student break out session
- ▶ Practical investment applications

# 2 quotes from Warren Buffett

10

- ▶ "I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will."
- ▶ "When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."
- ▶ Does this mean management doesn't matter?
  - ▶ No! It is hard to find a true compounder that doesn't have really good management



**Who are some good capital allocators—and why?**

# More Quotes from Warren Buffett

12

- ▶ “Culture, more than rule books, determines how an organization behaves.”
- ▶ "With superior management, a company may maintain its status as a low-cost operator for a much longer time, but even then unceasingly faces the possibility of competitive attack. And a business, unlike a franchise, can be killed by poor management."
- ▶ "You want to figure out ... how well that they treat their owners," he said. "Read the proxy statements, see what they think of — see how they treat themselves versus how they treat the shareholders. ... The poor managers also turn out to be the ones that really don't think that much about the shareholders, too." – Buffett on CNBC

# Why capital allocation is important 13

- ▶ What do we mean by capital allocation?
- ▶ Avenues for allocating capital
  - ▶ Organic growth
  - ▶ CAPEX
  - ▶ R&D
  - ▶ Dividends/buybacks
  - ▶ M&A
- ▶ How to assess capital allocation prowess
  - ▶ Not always easy: qualitative and quantitative
- ▶ First thing to know: very few things matter more than capital allocation

# Cove Street's “Proprietary” Management Assessment Framework

14

- ▶ Compensation & proxy statement analysis
- ▶ Scrutinizing prior M&A
- ▶ Buyback and dividend policies
- ▶ Tracking management objectives (TMO)
- ▶ Does management talk the talk?
- ▶ Insider transactions
- ▶ What has the stock done?

# Cove Street's Management Assessment Framework (cont.)

15

- ▶ Now, the hard aspects to assess:
  - ▶ Integrity of management
  - ▶ True motivations
  - ▶ Relationship with the Board
  - ▶ True skillset(s)
  - ▶ Willingness to stay in the role
- ▶ **Just because it is hard doesn't mean you can ignore it!**

# Don't be like this guy!

16





# Compensation & proxy statement analysis

17

- ▶ We will get into this in much more detail, but:
  - ▶ Proxy helps you understand motivations & incentives
  - ▶ Compensation levels & targets can tell you a lot about the company & Board
  - ▶ Is management aligned with you as a shareholder?

# Scrutinizing prior M&A

18

- ▶ Look at all deals done during time the CEO was in that role & working for the company
  - ▶ What has happened to free cash flow (FCF)?
  - ▶ Trends in ROIC
  - ▶ Margin changes
  - ▶ Revenue diversification
  - ▶ Synergy capture results
  - ▶ Size and type of deals: bolt-ons, tuck-ins, “transformational” deals
  - ▶ Organic growth as well?
  - ▶ Stated multiples paid
  - ▶ Divestitures are important as well
- ▶ Remember: empirical data says most M&A = value destroying for buyers

# Mark Mauboussin on M&A

19

- ▶ “Alfred Rappaport, a professor emeritus at the Kellogg School of Management, and Mark Sirower, a principal with Deloitte Consulting, explain why creating value through M&A is so challenging for a buyer. First, if the premium is too large the buyer cannot recoup its investment even if the deal makes strategic sense. Second, often competitors can replicate the benefits of a deal or take advantage of the buyer’s lack of focus as it goes through an integration process. Third, M&A requires payment up front for benefits down the road. This makes investors legitimately skeptical. Finally, M&A deals are generally costly to reverse.”
- ▶ <https://www.valuewalk.com/2017/03/mauboussin-buy-not-buy-checklist-assessing-mergers-acquisitions/>

# Buyback and dividend policies

20

- ▶ Buybacks
  - ▶ Size of authorization
  - ▶ Policy/strategy
    - ▶ Mechanical or opportunistic?
    - ▶ Used to offset option dilution
    - ▶ Use of a grid
    - ▶ Does management buy more on the way down (or up)?
  - ▶ Execution of buyback: value additive or destroying?
    - ▶ The tyranny of the share buyback

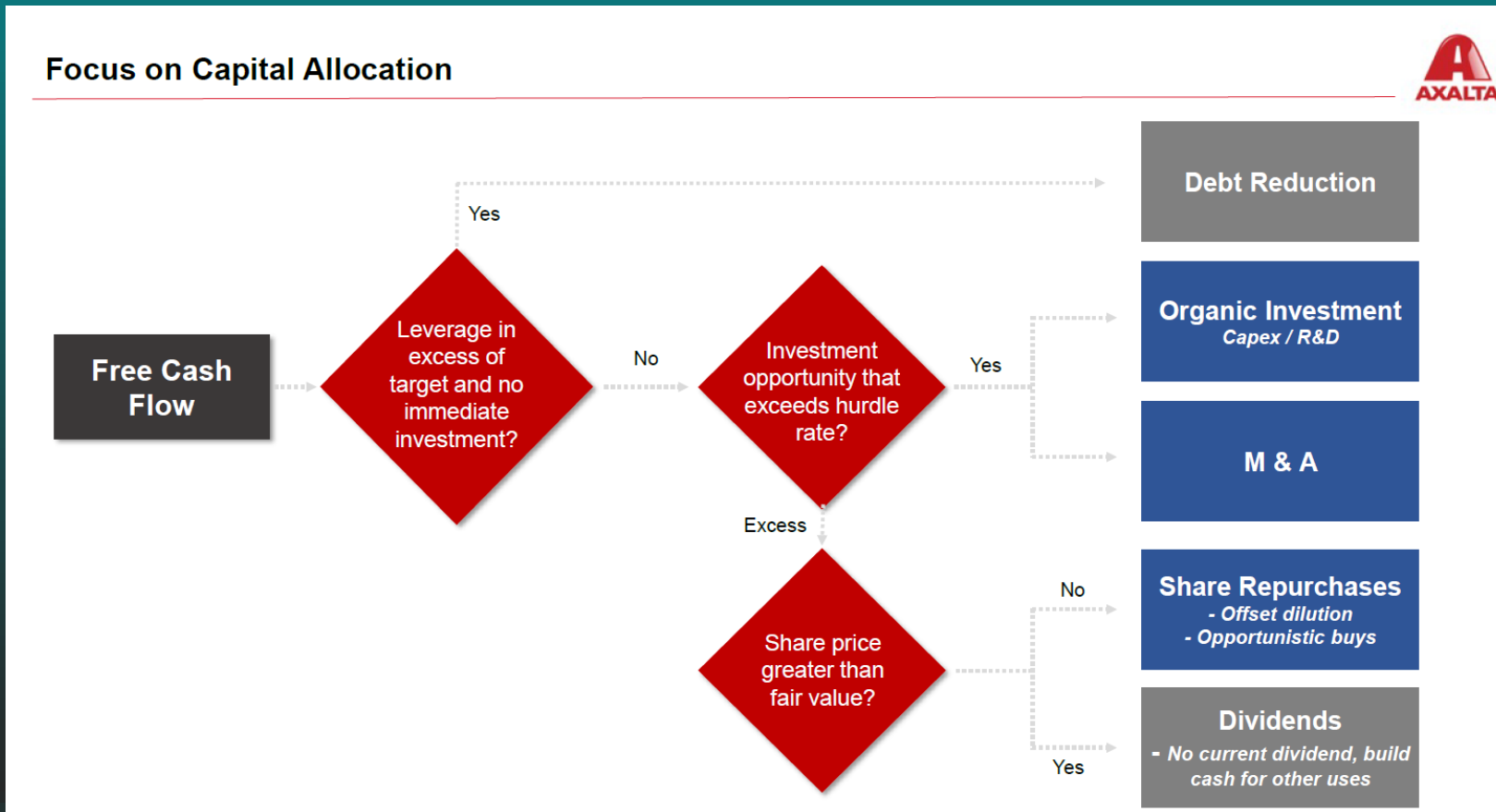
# Buyback and dividend policies (cont.)

21

- ▶ Dividends
  - ▶ Policy
  - ▶ History
  - ▶ Articulation of why dividend versus buyback
  - ▶ Cut the dividend in times of stress?
  - ▶ Dividend in relation to strength of balance sheet

# Example of a good capital allocation framework: AXTA

22



# Tracking Management Objectives

23

## ▶ What you want:

- ▶ Clearly defined objectives with some time horizon provided
- ▶ Management teams and Boards who do not move the goalposts when objectives are not met
- ▶ Compensation tied specifically to the stated goals

## ▶ What you don't want:

- ▶ Easy to achieve goals that require little improvement
- ▶ Management constantly changing what the company is targeting to achieve
- ▶ No accountability when goals are not met
- ▶ Management teams that receive full bonuses despite missing targets

# Tracking Management Objectives (cont.)

24

Historical Employee Programs			
Program	Time Period	Goals	Results
5 By 5	F2001-F2003	5% After-Tax Profit	✓ 5.9% PAT ending F2003
6+8: Teamwork To The Top	F2004-F2006	6%+ After-Tax Profit 8% 3-Year Revenue CAGR Begin LEAN Journey	✓ 7.0% PAT ending F2006 ✗ 7% Revenue CAGR ✓
Grow Lean	F2007-F2009	8% 3-Year Revenue CAGR 7%+ After-Tax Profit Working Capital "In the Teens"	✗ -6% Revenue CAGR ✗ 4.0% PAT ending F2009 ✓ ending in the teens
Five in One	F2010	5% After-Tax Profit	✓ 5.5% PAT ending F2010
Destination 2014	F2011-F2014	\$100m+ of Organic Revenue Annually 12%+ Operating Earnings By YE F14	✗ \$100m+ in F2011, F2014, \$70-80m in F2012, F2013 ✓ 12.1% EBIT Margin ending F2014
Destination Prime	F2015-F2017	5%+ Organic Revenue Growth Each Year 13%+ Operating Earnings by YE F17 Working Capital <13% by YE F17	✗ Organic growth CAGR ~3% ✓ 14.2% EBIT Margin ending F2017 ✗ ~14% ending F2017
Vision 2020	F2018-F2020	5%+ Organic Revenue Growth Each Year 15.5%+ Operating Earnings by YE F20	Ongoing (one year in)

Source: Baird Research, Company Reports



# Does management talk the talk?

25

- ▶ A lot of times CEOs don't even know what is important to shareholders
- ▶ Do they even use the buzzwords?
  - ▶ Return on invested capital
  - ▶ Creating shareholder value
  - ▶ Hurdle rate for investment
  - ▶ M&A discipline
  - ▶ Long-term
  - ▶ Divesting non-core businesses
- ▶ Is compensation tied to any of the above?
- ▶ Do their actions match what they say?
  - ▶ Gets back to TMO

# Recent quote from JPM CEO Jamie Dimon

26

- ▶ “We don't know what's going to happen next quarter, and I don't care.”

# Insider Ownership/Transactions

27

- ▶ Have insiders been buying or selling?
  - ▶ Is there cluster buying or selling?
- ▶ Do execs always sell when the price hits a specific level?
- ▶ Size of the buy relative to net worth of person
- ▶ 10b-5 plans
- ▶ Is buying/selling a relevant signal at all these days?
- ▶ How much stock does management own?
  - ▶ Did they buy in the open market?
  - ▶ Did they get it all through stock/option grants?
  - ▶ Do they consistently exercise and sell?
  - ▶ Has the % ownership gone or down up over time?
  - ▶ How meaningful is the dollar amount to management?

# Example of someone who really cares what the stock does

28

## ► CLH CEO Alan McKim

► What does it mean that he has sold shares over time?

Top Holders <a href="#">View All</a> <sup>1</sup>				
Holder	Common Stock Equivalent Held	% of Total Shares Outstanding	Market Value (USD in mm) <sup>2</sup>	Position Date
<a href="#">Wellington Management Group LLP</a>	6,496,316	11.60	372.5	Sep-30-2018
<a href="#">BlackRock, Inc.</a>	5,071,096	9.05	290.8	Sep-30-2018
<a href="#">The Vanguard Group, Inc.</a>	4,495,357	8.03	257.8	Sep-30-2018
<a href="#">McKim, Alan S.</a>	4,086,722	7.30	234.3	Nov-06-2018
<a href="#">ArrowMark Colorado Holdings, LLC</a>	3,022,871	5.40	173.3	Sep-30-2018

Holder	Dec-31-2004	Dec-31-2005	Dec-31-2006	Dec-31-2007	Dec-31-2008	Dec-31-2009	Dec-31-2010	Dec-31-2011	Dec-31-2012	Dec-31-2013	Dec-31-2014	Dec-31-2015	Dec-31-2016	Dec-31-2017	Latest
<a href="#">Wellington Management Group LLP</a>	-	-	-	190	185,022	-	-	189,200	-	3,449,791	4,604,053	6,072,906	6,140,425	6,064,866	6,496,316
<a href="#">BlackRock, Inc. (NYSE:BLK)</a>	4,800	449,198	109,136	993,720	1,413,066	3,813,148	3,751,380	3,163,228	2,799,444	3,234,237	3,298,576	3,557,611	4,089,106	4,205,918	5,071,096
<a href="#">The Vanguard Group, Inc.</a>	441,362	456,780	580,282	857,228	1,447,500	1,897,890	2,107,116	2,362,467	2,997,773	3,066,686	3,139,134	3,338,229	3,877,418	4,177,183	4,495,357
<a href="#">McKim, Alan S.</a>	-	8,331,524	7,290,382	6,070,382	5,620,382	5,441,182	5,095,182	4,891,516	4,773,736	4,602,506	4,599,806	4,619,296	4,545,015	4,400,681	4,086,722

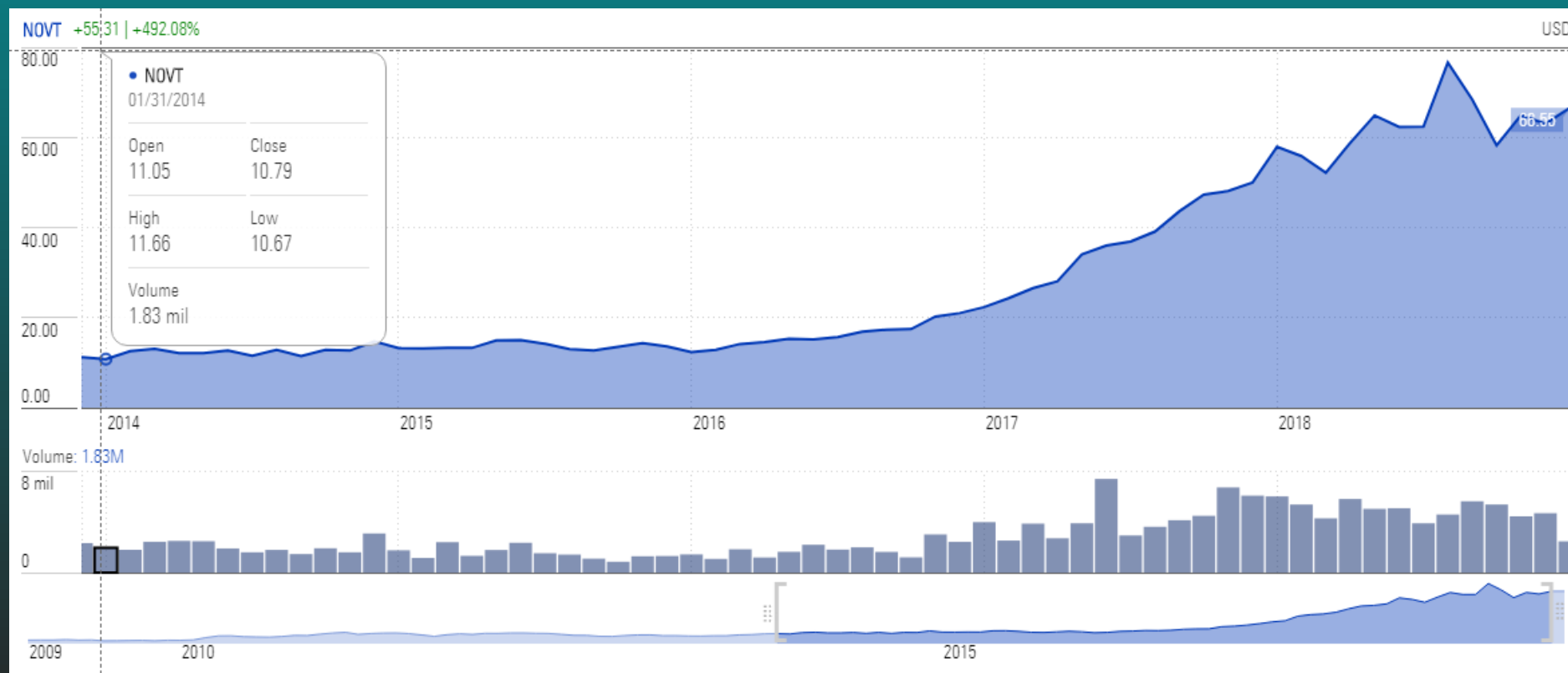
# What has the stock done?

29

- ▶ Some return assessment is necessary
- ▶ But, this is somewhat of a crude metric
  - ▶ Cyclical companies
  - ▶ CEO coming in at wrong/right time
  - ▶ Movements in valuation multiples
  - ▶ Industry tailwinds/headwinds
- ▶ But, if someone has been there for years and has overseen a multi-bagger...

# ...are they smart or lucky? Or both? (NOVT)

30



# How do you assess the “softer” stuff?

31

(Go back to slide 15)

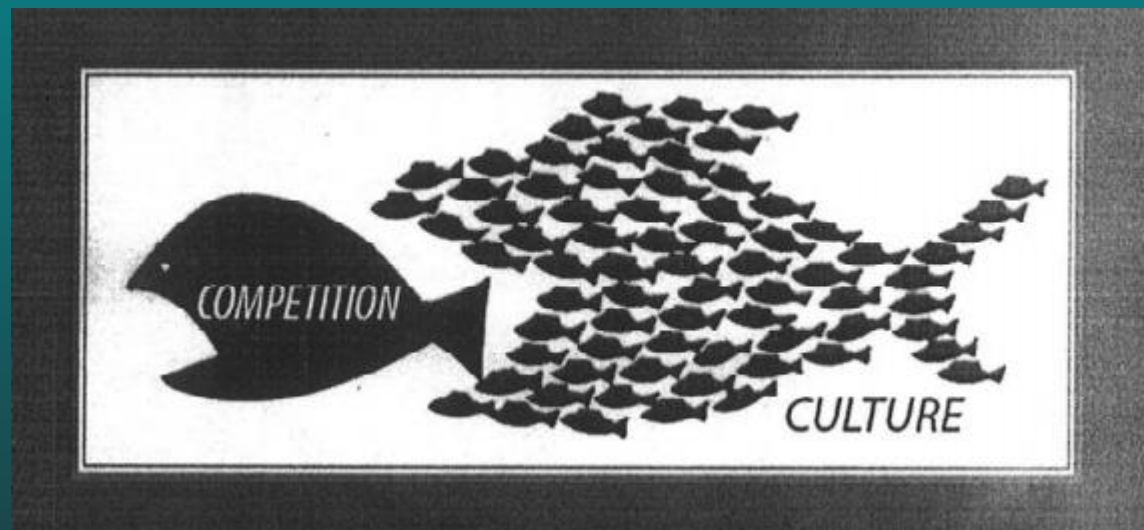
- ▶ Talk to former employees or colleagues
- ▶ Ask for personal references
- ▶ Look at Glassdoor and Indeed
  - ▶ Track these scores over time
- ▶ Meet them in person—but beware of the professional salesperson
- ▶ Read 10 years’ worth of 10-Ks, proxies, etc
- ▶ Use expert networks to source industry specialists
- ▶ Talk to other investors who own the stock (sparingly)

# How do you assess the “softer” stuff?

32

- ▶ What do the headquarters look like?
- ▶ Does the CEO commute from another city?
- ▶ Recently divorced?
- ▶ Brand new fancy car? Boat? Plane?
- ▶ First CEO job or is the 5<sup>th</sup> time?
- ▶ Would \$10mm make a difference to you?
- ▶ In the role for the status? The money? Or love of the company/business?
- ▶ Succession planning? Is there a deep bench?





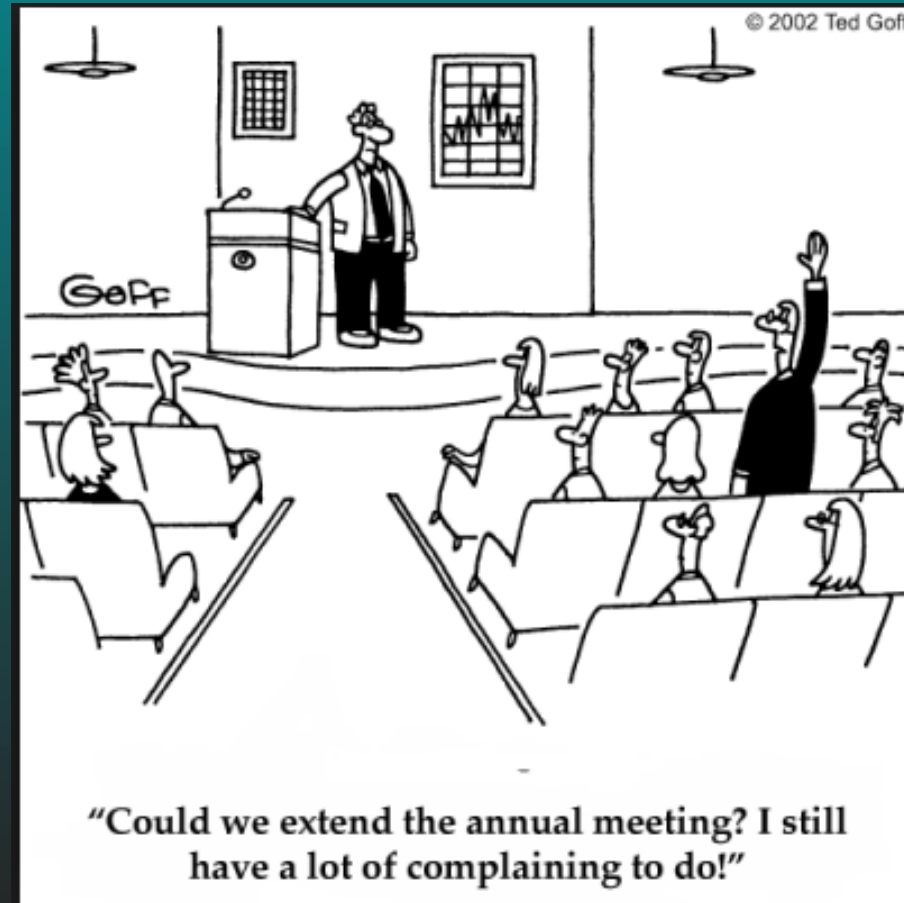
# Last, but never least: culture

34

- ▶ Peter Drucker: “Culture eats strategy for lunch.”
- ▶ Peter Kaufman: “The secret to leadership is to see through the eyes of all six important counterparty groups and make sure that everything you do is structured in such a way to be win-win with them. So here are the six. Your customers, your suppliers, your employees, your owners, your regulators, and the communities you operate in.”
- ▶ What kind of company culture is the management team building?
- ▶ Recommended reading:
  - ▶ Simon Sinek: *Leaders Eat Last*
  - ▶ Anything by Peter Kaufman of Glenair, including:  
<http://latticeworkinvesting.com/2018/04/06/peter-kaufman-on-the-multidisciplinary-approach-to-thinking/>

How many of you had read a full proxy statement before?

35



Source: Ted Goff

# The Proxy Statement

36

(AKA: SEC Form DEF 14A)

- ▶ What is the purpose of the proxy statement from the company's perspective?
  - ▶ Lay out compensation practices
  - ▶ Discuss governance policies
  - ▶ Showcase the Board Members and their various committee roles
  - ▶ Explain everything to be voted on at the Annual Meeting
  - ▶ Present material that shareholders use to vote their shares

# The Proxy Statement

(An underappreciated gold mine of information)

- ▶ What is the purpose of the proxy statement from investors' perspective?
  - ▶ Figure out how to vote their shares
  - ▶ Understand what drives management's behavior
  - ▶ Decipher the company's goals and focus
  - ▶ Determine the role of the Board vs. named execs
  - ▶ Make qualitative assessments about whether management is stealing for you or from you
  - ▶ Remember: ISS and Glass Lewis essentially determine what constitutes good corporate governance

# Key Elements of the Proxy

38

- ▶ Board Members and Board structure
  - ▶ Election of directors
- ▶ Compensation policy (long term & short term)
- ▶ Insider & outside shareholder ownership structure
  - ▶ Management/director share ownership requirements
- ▶ Employee agreements and severance policies
- ▶ Comparative set for benchmarking
  - ▶ Role of compensation consultant
- ▶ Annual say on pay
- ▶ Perks, related party transactions
- ▶ Certification of auditor
- ▶ Common and uncommon proposals

# Evaluating Board Members

39

- ▶ Biographies and backgrounds
- ▶ Diversity of experience, race and gender
- ▶ Independent or not?
- ▶ Tenure
- ▶ Average age
- ▶ Level of engagement
- ▶ Committee involvement
- ▶ How has the company performed during tenure?



“What if we don’t change at all ...  
and something magical just happens?”



# Evaluating Board Members (cont.)

41

## ▶ What you don't want are people who:

- ▶ Are there just to cash a check
- ▶ Are golfing buddies with the CEO
- ▶ Have no relevant experience whatsoever
- ▶ Are on the Board just because of “star” power
- ▶ Will not question management's goals, projections or strategies
- ▶ Only read the Board memo on the plane ride over
- ▶ Take advantage of company perks

# Evaluating Board Members (cont.)

42

- ▶ What you do want are people who:
  - ▶ Are not afraid to be contrarians
  - ▶ Think of the shareholders as the true owners
  - ▶ Hold execs' feet to the fire
  - ▶ Own a lot of stock in the company
  - ▶ Can use their network to help the company
  - ▶ Don't need the Board fees to put food on the table
  - ▶ Understand that the Board role is not forever
  - ▶ Are willing to engage with outside shareholders

# Board Structure

43

- ▶ Split Chairman and CEO?
- ▶ Size of Board
- ▶ Number of independents
- ▶ Staggered or elected annually?
- ▶ Committee makeup
- ▶ Age limits
- ▶ Stock ownership requirements
- ▶ Lead Director?

# Board Structure (cont.)

44

- ▶ You will never understand the internal dynamics unless you are on the Board
  - ▶ **But, in general, remember these (anecdotal) lessons:**
    - ▶ Chairman holds a lot of power
    - ▶ Boards move VERY slowly
    - ▶ Few people want to be the jerk in the boardroom
    - ▶ You need a second for any motion
    - ▶ Committees are mini-silos
    - ▶ Board meetings serve as reasons for people to get together
    - ▶ Powerful CEOs can dominate a Board
    - ▶ Most people are not paying attention if things are going well
    - ▶ These people have other jobs and lives

# Compensation

45

- ▶ What % of compensation is at risk vs. fixed?
- ▶ Executive salaries
  - ▶ Rate of yearly increases
  - ▶ Excessive for the role or company size?
- ▶ Short-term comp (bonus)
  - ▶ Metrics
  - ▶ Targets
- ▶ Long-term comp (equity)
  - ▶ Options, PRSUs, RSUs
  - ▶ Vesting periods
  - ▶ Metrics
    - ▶ TSR
  - ▶ Multi-year period?

# Compensation (cont.)

46

## ► Reasonable salary, but...

Name and Principal Position	Year	Salary (\$) <sup>(1)</sup>	Bonus (\$)	Stock Awards (\$) <sup>(2)</sup>	Option Awards (\$) <sup>(2)</sup>	Non-Equity Incentive Plan Compensation (\$) <sup>(3)</sup>	All Other Compensation (\$) <sup>(4)</sup>	Total (\$)
Michael Rapino President, Chief Executive Officer and Director	2017	2,416,667	1,000,000	58,631,538	1,720,677	6,766,667	80,211	70,615,760
	2016	2,300,000	—	574,992	1,959,351	5,520,000	83,898	10,438,241
	2015	2,300,000	—	1,266,500	1,250,555	5,060,000	83,324	9,960,379

- What do you consider excessive?
  - What if the stock has done REALLY well?

# Compensation (cont.)

47

- ▶ The metrics and targets are REALLY important
  - ▶ Aggressive or easy to reach?
  - ▶ Targets: EPS and sales growth or ROIC and Free Cash Flow?
  - ▶ Does management get a bonus or share grants even if targets are missed?
  - ▶ Metrics measured over multi-year period?
  - ▶ Equity comp tied to targets or annual “gifts?”
- ▶ Overall question: does the compensation appear reasonable and is it contingent on company's success?

# Other Key Proxy Components

48

- ▶ Employee agreements and severance
  - ▶ Does the company offer employee agreements?
  - ▶ Severance:
    - ▶ Change in control
    - ▶ Without cause
    - ▶ With good reason
    - ▶ Death/disability/retirement
    - ▶ Is the amount egregious?



# Severance/Change in Control

49

► Back to our friend from Live Nation:

Name	Benefit <sup>(1)</sup>	Termination w/o Cause (\$)	Termination w/Good Reason (\$)	Death (\$)	Disability (\$) <sup>(2)</sup>	Change in Control (\$)
Michael Rapino	Severance <sup>(3)</sup>	22,560,000	22,560,000	14,040,000	14,040,000	—
	Equity Awards <sup>(3)(4)</sup>	94,221,028	94,221,028	94,221,028	94,221,028	94,221,028
	Medical Benefits <sup>(3)</sup>	180,000	180,000	—	—	—
Total		116,961,028	116,961,028	108,261,028	108,261,028	94,221,028

► Is this egregious?

► Is this a great incentive to sell the company?

► Or would it dissuade a potential buyer?

# Other Key Proxy Components

50

- ▶ Insider ownership
  - ▶ How much does management own?
  - ▶ How long do directors/execs have to reach ownership requirements?
  - ▶ Do directors own material amounts of stock?
- ▶ List of major outside shareholders
  - ▶ Passives (ETFs) or active managers?
  - ▶ Presence of activists?
- ▶ Presence of dual class shares
  - ▶ Owner-operator or someone who can't be thrown out?

# Other Key Proxy Components

51

- ▶ Peer set
  - ▶ What purpose does the comp consultant provide?
  - ▶ Is the company comparing itself to good or mediocre companies?
  - ▶ How has the company performed relative to the peer set?
- ▶ Say on pay
  - ▶ Annual or every 3 years?
  - ▶ How did shareholders vote last year?

# Other Key Proxy Components

52

- ▶ Certification of auditor
  - ▶ Have you heard of the auditor?
  - ▶ Does it change frequently?
- ▶ Perks and related party transactions
  - ▶ Perks: plane use, company apartment, company car, etc.
  - ▶ Related party transactions: family members working for company, commercial relationships with execs or Directors
    - ▶ See slide on red flags
- ▶ Burn rate
  - ▶ High burn rate= excessive share compensation?

# Other Key Proxy Components

53

## ▶ Common Proposals

- ▶ Election of director
- ▶ Certification of auditor
- ▶ New compensation plan/ability to issue new shares
- ▶ Say on pay
- ▶ By-law changes

## ▶ Less common Proposals

- ▶ Board de-staggering
- ▶ Shareholder nominations for Directors

# Breakout Session

54

- ▶ Break up into groups of 4-5 people
- ▶ One half of the room focus on SNBR
  - ▶ One half focus on SKX
- ▶ Take about 5 minutes to talk about the companies
- ▶ We will ask for one group to volunteer to talk about SNBR
  - ▶ And one group to talk about SKX
- ▶ Topics to consider:
  - ▶ Should shareholders be happy with the proxy contents? Why or why not?
  - ▶ What elements stand out to you—good or bad?
  - ▶ Does reading through the proxy make you want to trust management and the Board more—or less?

# Case Study: SNBR

55

- ▶ 2017 proxy statement
  - ▶ **Good:** ROIC over 3 years, 75% performance stock, reasonable salaries given the market cap, aggressive targets for metrics (\$2.75 in EPS), 3 year compensation plans, diversity of Board
  - ▶ **Bad:** Half year results and semi-annual targets, staggered Board
  - ▶ Recall that this company was “activisted”

# Case Study: SKX

56

## ► 2017 proxy statement

- **Good:** directors not compensated excessively, 4 year vesting of restricted shares, no employment contracts
- **Bad:** Staggered board, A/B (dual class) stock, related party transactions, only 5 independent Directors, multiple family members on the board
- **More Bad:** same Chairman/CEO, no diversity on Board, net sales growth (quarterly!) is the only annual metric, no RSUs aside from the ones for the new CFO, total comp is pretty substantial—as is the CIC, 1500:1 CEO pay ratio



# Proxy Red Flags

57

- ▶ Dual class share structure (not many Berkshire Hathaways out there)
- ▶ Staggered board (sadly this is somewhat commonplace)
- ▶ Board members who have been there for decades
- ▶ Management and board members who own no stock
- ▶ More than one paragraph of related party transactions
- ▶ Constant auditor changes
- ▶ Peer set changes every year
- ▶ Different compensation metrics each year
- ▶ Very easy to reach profitability or growth targets
- ▶ Compensation consistently looks egregious
- ▶ Management gets equity simply for showing up (time vesting)
- ▶ Excessive list of management perks
- ▶ Tax gross ups (company basically pays execs' taxes)

# Practical Implications/Takeaways

58

- ▶ In general, making decisions under uncertainty is really hard
  - ▶ You can never know 100% of what you would like to know
- ▶ Understanding management is tough and it is time consuming
  - ▶ But not many things are more important
- ▶ So much of assessing management is subjective and is tied to a “smell test”
- ▶ Best predictor of the future is what happened in the past
- ▶ True integrity is hard to fake
- ▶ Incentives guide you to what someone is likely to do
- ▶ You must develop a level of skepticism—assume people are lying to you
- ▶ Key questions to ask yourself:
  - ▶ Do you trust these people?
  - ▶ Would you want your kids to work at the company?
  - ▶ Do you feel like the execs truly understand the business?
- ▶ You will make mistakes over time **BUT LEARN FROM THEM!**