# THE ESG FILES

## EXPLORING THE INVESTMENT CONSIDERATIONS OF ESG MATTERS

# Dual Class or Second Class?

## An Examination of Dual Class Share Structures


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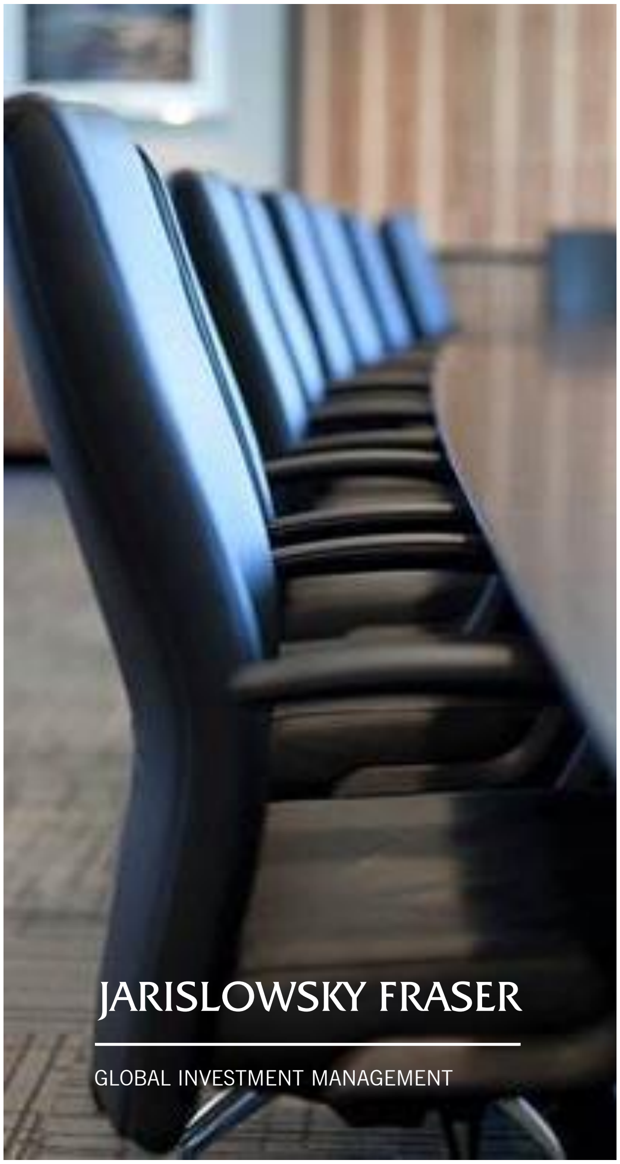
**Executive Summary:**

- The trend for dual class share structures in newly public companies is growing globally, especially within the technology sector.
- Due to the misalignment of voting and economic interest, dual class share structures are not generally considered best practice from a governance perspective.
- There is evidence that, on average, the effect of a dual class share structure is linked, on average, to neutral to positive shareholder value creation for a period of time.
- Jarislowsky Fraser takes a nuanced case-by-case view of dual class share structures that focuses on the alignment and behaviour of the controlling party relative to long-term shareholders, the rationale for unequal voting, and the mitigants against potential abuse of minority shareholders.

### What Are Dual Class Shares?

Dual class share structures involve one or more classes of shares with voting rights that are superior to other classes of shares and asymmetric to the holders' economic interest in a company.



## Introduction

Jarislowsky Fraser has a longstanding commitment to integrating Environmental, Social and Governance (ESG) factors throughout our research process. We firmly believe that good governance is the foundation for strong financial, social and environmental outcomes. In light of this and recent trends, we examine here the significant governance implications of dual class share structures.

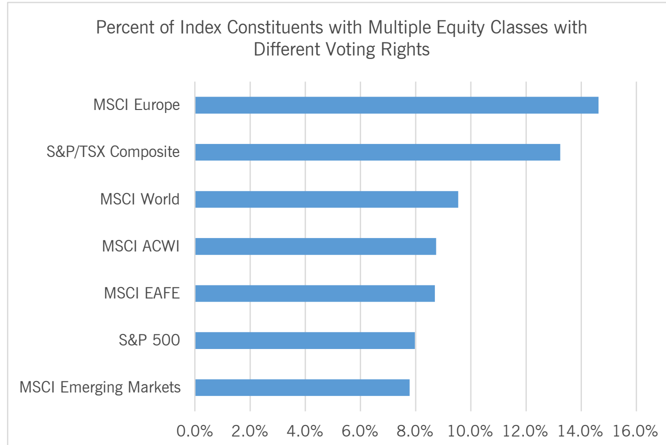
**Far from being an anachronism, family-owned businesses and dual class share structures are on the rise globally and remain an important part of global and Canadian markets.**

Dual class share structures exist when a company issues different types of shares, each class of which typically has different voting and, possibly, dividend rights. Often, these structures are put in place at family-controlled or founder-controlled firms so the discussion of family firms and dual class shares go hand in hand: 89% of dual class firms in the Russell 3000 Index have the founding family as owners.[1]

Far from being an anachronism, family-owned businesses and dual class share structures are on the rise globally and remain an important part of global and Canadian markets. As illustrated in Exhibit A, 8.7% of all companies listed on the MSCI All Country World Index have multiple equity classes with unequal voting rights, and the prevalence varies by geography, with it being more common in Europe and Canada. In Canada, family firms and dual class share structures have long been a sizeable component of the economy, with 13.2% of companies listed on the S&P/TSX Composite Index having multiple classes of shares with unequal voting rights[2] and publicly listed family firms accounting for ten of Canada's twenty-five largest employers.[3]

Globally, the public listing of US technology firms and the growth in emerging market listings are both trends that highlight the importance of multiple share classes. For example, although only 8.0% of S&P 500 constituents have multiple classes with different voting rights,[4] one-fifth of US IPOs in 2017 involved dual class shares.[5] Similarly, while the MSCI Emerging Markets Index currently has the lowest representation of unequal voting rights, family-owned businesses play a very important role in emerging market economies. In fact, McKinsey forecasts that, by 2025, nearly 40% of the world's companies with revenues greater than $1 billion USD will be emerging market family-owned businesses, up from 15% in 2010.[6]

### Exhibit A: Prevalence of Unequal Voting Stocks by Index




JFL Analysis based on MSCI ESG Data.

## Advantages and Disadvantages

**Advantages of dual class share structures include:**

- Access to growth capital for companies without diluting the ability to maintain the long-term vision of the founders/controlling shareholder.
- Allow management to focus on managing the company rather than the short-term interests of some shareholders or hostile takeovers.
- Allow public investors to share in, what can be, better than average economic value creation from founder-controlled companies that may otherwise remain private.

**Disadvantages of dual class share structures include:**

- Fewer formal accountability measures aimed at reinforcing alignment with minority shareholders, which can lead to poor outcomes for these shareholders.
- Entrenchment of controlling shareholders that can allow entrepreneurs or families to retain control for longer than beneficial to the company and shareholders.
- Fewer channels of communication between the board and minority shareholders.
- The lack of shareholder pressure can contribute to a lack of transparency.

### Debate: Control versus Democracy

The conventional view, supported by many of the proxy advisory services, is that dual class share structures are contrary to good governance and shareholder democracy. Institutional Shareholder Services (ISS) and Glass Lewis, the two pre-eminent proxy advisory companies, both support the principle of one share, one vote, with Glass Lewis stating that dual class share structures generally reflect negatively on the company's corporate governance. Both therefore generally recommend that shareholders vote for proposals to eliminate dual class share structures and against proposals to create them, except in the case of strict foreign ownership restrictions that may necessitate them.[7]

**Some argue that a dual class share structure plays an important role in the Canadian context.**

Organizations in the USA tend to take a more negative view of dual class share structures than in Canada, with the Council of Institutional Investors submitting letters to the NASDAQ and NYSE asking them to require any newly listed companies with a dual class share structure to impose a mandatory seven-year maximum period before the structire is dissolved (commonly referred to as a time-based "sunset clause").[8]

On the other hand, some argue that a dual class share structure plays an important role in the Canadian context, in that this allows founders to take their companies public without fear that they will be taken over by international companies and turned into "branch plants". Similarly, the idea that a dual class structure allows a company to go public but retain ongoing family control may be appealing in that a family-controlled company may be less susceptible to short-termism and actually be more aligned with shareholder interests. The Institute for Governance of Private and Public Organizations (IGOPP) is a strong advocate of dual class share structures, believing that even time-based sunset clauses would have led many successful Canadian companies to either remain private or to have been taken over by American companies.[9] Without this protection, Canada may miss out on the economic and social value of having family-run companies that remain headquartered domestically.[10] The Canadian Coalition for Good Governance (CCGG) recognizes the argument that mandatory single class shares may prevent Canadian entrepreneurs from taking their companies public, thereby hindering Canadian entrepreneurism, but nonetheless states that utilizing a single class of voting common shares is a best practice.[11]

The Rotman School of Management Clarkson Centre for Board Ethics identifies three important characteristics which are common to family-controlled firms and beneficial to long-term shareholders:

1. Commitment to the principles and values underlying the company, which may help to create a productive, unified culture;
2. A long-term view that is inherent in family-controlled firms with a clear plan for family succession and, therefore, an interest in long-term value creation;
3. Ability to change, whereby family-controlled firms may be more willing and able to adopt new strategies quickly.[12]

**Overall the historical evidence suggests that dual class share structures, on average, have outperformed the broader markets for a meaningful period of time.**

### What does history tell us about the share price performance of dual class share companies?

Overall, the historical evidence suggests that dual class share structures, on average, have outperformed the broader markets for a meaningful period of time. Before reviewing some of the findings of these studies, we think it is important to highlight a couple of things about these (and all historical capital markets) studies:

- **"On average" doesn't matter if your head is in the oven and your feet are in the freezer.** There are fewer examples of the proverbial "average" dual class share company and the range of outcomes can be wide. Our experience is that some dual class share companies are able to create significant outperformance over longer periods of time, but others are able to do an equally impressive job of destroying value for minority shareholders. The biggest failures may not even be reflected in the data sets as they may not have survived to the date at which the sample was selected, so survivorship bias likely plays some role.
- **History is a guide not a map.** The conditions that allowed for the performance in the past may not exist in the future. For example, higher levels of scrutiny on ESG or changes to index inclusion of

dual class share issues may lead to changes in the demand for dual class share company subordinated stock.

- **Sector biases.** One only has to look at the performance of tech companies over the last five years to see how the outperformance may be more closely linked to the fundamentals of the business than its governance structure. The same could be said for sector performance seen during various periods, for example, the energy sector that includes few; DCS companies.
- **Correlation ≠ Causation.** Although it can be easily forgotten amongst the compelling charts and articulate theories, these studies highlight interesting, potentially relevant trends, in a dynamic system and are not controlled experiments looking at fundamental laws of nature.

That being said, the evidence and our own experience suggest to us that there are few reasons to dogmatically exclude dual class share companies from our investable universe or to assume that they need a less intense approach to analysis or active ownership. We examine the particular details of each company rather than draw sweeping generalizations, and seek the right mix of companies that meet our standards to form resilient portfolios designed to deliver superior long-term risk-adjusted returns.

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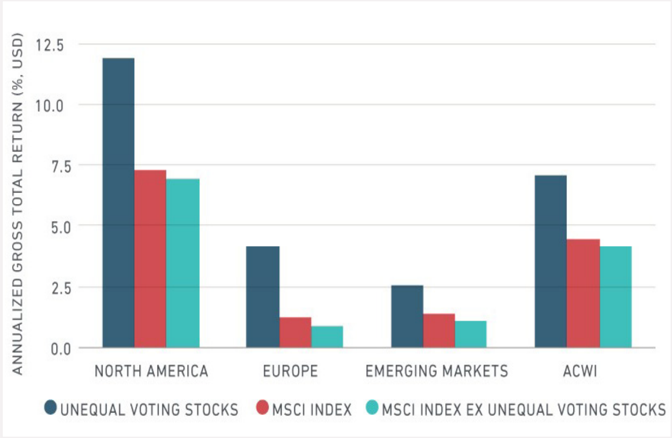
With these caveats in mind, it is nonetheless interesting to examine the relationships between dual class/family control structures and shareholder value creation. In general, the balance of studies appears to suggest that dual class share structures have at least a non-negative impact on financial performance. A 2019 global review by HSBC found that there is no conclusive evidence linking company performance to equal voting rights once controlled for the fact that US technology companies tend to have dual class share structures and have outperformed since 2004.[13] More conclusively, a 2018 MSCI study (See Exhibit B) showed stocks with unequal voting in aggregate outperformed the market from November 2007 through August 2017; though some of this was explained by performance in the technology sector, MSCI found most was due to company-specific effects.[14] This applied to all geographies studied – North America, Europe, Emerging Markets, and the MSCI All Countries World Index.

**Exhibit B. MSCI Analysis of Performance of Unequal Voting Stocks by Index[15]**




Source: MSCI; data from November 2007 to August 2017

**Studies of the effects of family control and dual class structures in the Canadian context tend to find some uniquely Canadian results.**

In addition, neither the structures nor their effects are necessarily permanent. A study of American firms undertaken by the European Corporate Governance Institute found that, on average, dual class share firms have higher valuations at and subsequent to their IPO, but that this valuation premium decreases over time, leading the authors to conclude that dual class share structures should be supported during IPOs, but should include time-based sunset provisions.[16] A Harvard Law School discussion paper argues that the potential advantages of dual class share structures decrease, and their potential costs increase as time passes from IPO. It therefore advocates for time-based sunset clauses with non-affiliated shareholders able to vote to extend the structure.[17] However, disagreement exists here as well, with others arguing that mandatory sunset clauses would risk a premature dismantling of the dual class structure that may decrease shareholder value.[18]

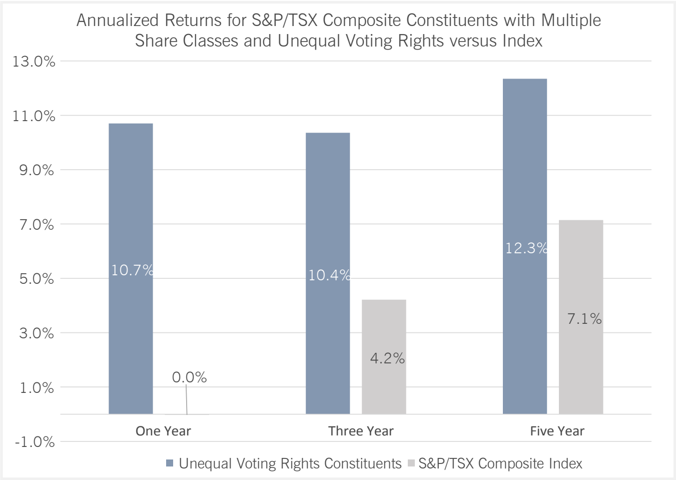
Studies of the effects of family control and dual class structures in the Canadian context tend to find some uniquely Canadian results. IGOPP summarized thirty-seven empirical studies and found either contradictory or inconclusive links between share structure and performance, with a general tendency for more recent studies to be more favourable.[19]

A Rotman School of Management study examined the performance of Canada's largest family-controlled issuers, defined as a company in which a family member or group has at least 30% voting control; 18 of the 23 family-controlled firms in the study have dual class share structures. The study concludes that the family-controlled firms outperformed their non-family-controlled peers and the index between 1998 and 2012: family-controlled firms outperformed non-family firms by 1.6% as measured by total shareholder return compound annual growth.[20] It is the combination of family control and dual class shares that are linked to greater outperformance: family firms with unequal voting rights outperformed non-family firms by 2.7% and outperformed family firms with equal voting rights by 3.7%, though the latter has a small sample size of only five firms. Similarly, controlled non-family firms lagged widely held non-family firms by 1.3%. The same study found that family management also appears to add value, with family-managed family firms outperforming externally managed family firms by 0.9%. A 2017 study also found significant outperformance amongst American dual class firms so long as the superior voting shares are held by the founding family.[21] A 2018 National Bank of Canada study also found that Canadian family-owned companies outperform the index by 2.3%.[22] The study suggests that this is because family-owned companies are often more aligned to shareholders, with longer-term focuses, lower leverage, and lower employee turnover.[23]

Our own analysis created a market-capitalization-weighted index of S&P/TSX Composite listed companies that have multiple share classes and unequal voting rights. When compared to the S&P/TSX Composite Index as a whole, we found that the companies with unequal voting dual class share structures significantly outperformed the index based on one-year, three-year, and five-year annualized total shareholder return. See Exhibit C. Of course, sector biases play a role: for example, energy and real estate firms are less likely to be family-owned or have dual class share structures, while a growing number of technology and media companies have a dual class share structure. As illustrated in Exhibit D, dual class share companies with unequal voting rights continue to outperform the S&P/TSX Composite Index when the Energy Sector is removed, but the outperformance is less extreme. In the Canadian context, the success of Shopify contributes significantly to the outperformance of dual class share structures, though Shopify may be an example of a company that could have delayed going public if dual class share structures were not an option.

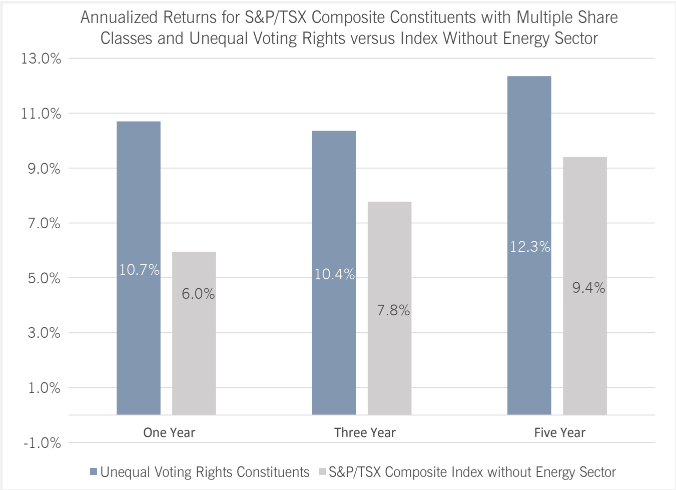
**...dual class share companies with unequal voting rights continue to outperform the S&P/TSX Composite Index when the Energy Sector is removed, but the outperformance is less extreme.**

**Exhibit C. JFL Analysis of the Performance of Unequal Voting Stocks in Canada**




Source: JFL Analysis based on Bloomberg and MSCI ESG Data.
As at September 30, 2020.

**Exhibit D. JFL Analysis of the Performance of Unequal Voting Stocks in Canada Without Energy Sector**




Source: JFL Analysis based on Bloomberg and MSCI ESG Data.
As at September 30, 2020.

### Jarislowsky Fraser's Stance: Best Practices—Not Dogma

Consistent with our approach to deep, fundamental analysis that integrates material ESG factors throughout our process, we take a non-dogmatic approach to dual-class structures. We have seen significant shareholder value created by family-controlled firms with these structures, and, where we find good alignment and practices, we may invest in dual class share companies. Although we generally prefer a one-vote-per-share capital structure, we do not systematically object to a capital structure of subordinate voting shares. Instead, we assess each case individually to evaluate:

- Alignment and behaviour of the controlling party;
- Justification for unequal voting; and
- Mitigants against potential abuse of minority shareholders.

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We seek the following best practices:

- We expect "skin-in-the-game", meaning we want management and the controlling shareholder to have significant equity and economic interest, even if it could be asymmetric to their voting power.
- We also seek evidence of aligned compensation that is transparent and focused on long-term performance.
- One element we do believe should be mandatory is coattail provisions, which would ensure equal treatment and tag-along rights for any M&A activities.
- In general, we advocate for some level of formal accountability and communication between the board and all minority shareholders, such that all common shares have some voting rights (generally supporting a maximum 4:1 voting ratio).
- In terms of board independence, we seek a strong and suitably empowered Independent Chair or Lead Director, and expect the total number of directors on the board to be proportional to voting interest up to two-thirds for the controlling shareholder. However, if the controlling shareholder is related to management, we expect the board to be two-thirds independent.
- We also look for majority independent committees with independent committee chairs, and note that committee independence is particularly important for Audit and Compensation Committees.
- Other than for foreign ownership rules, we believe that dual class shares should represent a transitional phase between private and full public ownership. We see value in entrepreneurs retaining control of their company but generally believe that rationale for the dual class share structure diminishes once the founder is no longer meaningfully involved. For this reason, we believe it important that the dual class structure should not automatically extend beyond the entrepreneur's tenure, instead requiring periodic subordinate shareholder approval to maintain the structure once ownership and/or involvement declines significantly. We generally believe that these ownership-based sunset clauses will better serve the interests of long-term investors than strict time-based sunset clauses.
- Although not an absolute requirement, we see significant value in a periodic review of the dual class share structure at appropriate points in the life-cycle of a company to ensure alignment with future objectives and needs. Overall we strongly believe that the onus is on the management and board to regularly justify the structure to shareholders.

The following case studies help to elucidate our approach, which is grounded in principles as opposed to rules.

### Coattail Provisions: Is this something I can ride?

Since 1987, all companies on the S&P/TSX with multi-class share structures are required to have a coattail provision as a way to bridge the gap in economic and voting interest in case of an attempted company takeover. Typically, the provision mandates that no offer to acquire a class of controlling shares would be valid without the acquirer making a concurrent offer on the same terms to the other class of shareholders. At first glance, this appears to ensure that at least in the case of a takeover offer, the owners of the subordinated share classes would be treated the same as the multi-voting class of shares. However, it appears that the devil is in the details and not all coattails are suitable rides for minority shareholders.

For example, the recent unsolicited offer by Altice and Rogers for Cogeco Inc (69% controlled by Gestion Audem) and Cogeco Communications (83% controlled by Cogeco Inc) had a structure that could have legally allowed the coattail provisions to be circumvented. The result would have allowed the controlling shareholder to reap a significant premium relative to the subordinated shares on the transaction. Although the subordinated shareholders would have still received a premium to the prior share price and had the opportunity to vote on whether or not to waive the coattail provisions at the two entities, their power was not equalized in the process. Ultimately, the refusal of the controlling shareholder to engage in negotiations resulted in the bid expiring without ever being brought to a shareholder vote. This case has some lessons:

1. Not all coattail provisions are created equal: It is important to look into more detailed elements of the governance such as waiver rights for minority shareholders, transfer rights for the controlling shareholder, and whether or not all forms of change in control are covered.
2. Complexity cuts both ways: Complex corporate structures can create opportunities for financial optimization but can also decrease or obscure the true power of coattail provisions.
3. Alignment can come from other sources: A controlling shareholder with similar general goals as a long-term investor, change of control compensation measures and a strong independent board can enhance alignment of outcomes when it comes to transactions, regardless of the share structure.

In general, we view a coattail provision as a minimum standard for companies with a dual class share structure and appreciate more expansive and comprehensive coattail provisions, without relying on them too strongly as part of our value creation thesis.

### Big Tech: Who is in charge of the internet?

The role of dual class share structures in rapidly emerging and potentially disruptive sectors like tech is a growing trend with more than one-third of tech IPO's going public with some kind of dual class share structure. The WeWork failed IPO (contemplated to have the founder with a 20:1 advantage in voting rights) and subsequent restructuring highlighted how less accountable governance and poor alignment of management can drive poor shareholder outcomes.

On the other hand, the recent outperformance of companies like Shopify, Facebook, Google and Zoom, all companies with dual class shares, matched their rapid rise in importance in society during the pandemic. Many suggest that the rapidly evolving nature and volatility of these fast growing and innovative industries require a firmer, longer-term steward that may be difficult to get with widely distributed and liquid voting rights. In fact, there is some evidence that higher innovative output is related, for a period of up to ten years post IPO, by these types of structures.[24] In many cases, the visionary founder(s) can provide a long-term strategy and direction that could be more difficult to implement in a timely and orderly fashion with a single class of shareholders.[25] While this may be true for a period, it is unclear that this needs to be true forever or in all cases.

One study showed that the valuation premiums seen at IPO by dual class share companies dissipates due to aggravation of the agency problems and growing gap between voting and economic interest.[26] Certainly as the founders step away from actively managing the business, the need for concentrated control seems less justified. As an industry matures and scales, the pace of growth may moderate or the need for greater representation of more diverse points of view could prove useful. A good management team will likely try to incorporate emerging issues and a broader stakeholder base into their long-term outlook, but that engagement can be encouraged through a more widely distributed and equal voting structure. In addition, there has been success in the sector with single voting classes of shares, notably Amazon and Microsoft.

Ultimately, we believe that there are ways for management and the board of fast-growing dominant tech companies to expand their capacity and accountability and to balance innovation and long-term vision with agency and scale issues in a timely and orderly fashion through:

1. Sunset clauses/dilution triggers: These are provisions that convert all shares to a single class after a specific time period or change in the controlling shareholder holdings or identity. More recently, there have been proposals for a periodic review that allows subordinated shareholders to vote to approve an extension of the dual class share structure beyond a certain date, ownership or involvement threshold.
2. Financial alignment with long-term shareholder outcomes: Three important markers of financial alignment include high equity ownership, aligned compensation and percentage of net worth.

3. Value of diversity: A culture that values and encourages greater diversity and independence on boards and the organization as a whole can have better outcomes. An example of this could be Facebook's recent board additions of women with diverse life and industry experiences.
4. Independent advice and counsel for the board on key issues: Examples of this are Google's external advisory board on Ethical AI use and Facebook's Safety Advisory Board. These can provide improved representation of stakeholders that support the value of the platforms, broader insights on key issues and a general sounding board for CEO's and boards that are clearly brilliant but may not have the (lived) experience necessary to recognize or manage complex and rapidly evolving social issues in a timely and appropriate manner.

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