Hong Fok: More safeguards for minority shareholders?

While a company may have complied completely, the rules as they are may not fully benefit minority shareholders

By MAX YUEN TEEN

RECENT reports in The Business Times have highlighted issues in the conduct of the AGM and executive pay at Hong Fok Corporation. In his commentary “Pay attention to executive salary plans” (BT, April 28), Mr. Hong rightly pointed out the relatively large salary drawn by the executive directors and other employees, who are related to the family controlling shareholder is a concern. Both the issue of the conduct of the AGM and high executive pay can potentially harm the interests of minority shareholders.

When we look at the actions of Hong Fok over a longer period, such as the past five years, the vulnerability of minority shareholders in the company becomes even more evident. Hong Fok’s case also provides a clear illustration of how our rules on executive pay and interested person transactions can be improved, especially when it comes to companies controlled by families or founders.

Over the last five financial years, the company has paid cash dividends to shareholders only once, back in 2007. That year, it paid an interim cash dividend of 12 cents per share, amounting to a total of about $36 million. This was to utilise the tax credits under section 44A of the Incomes Tax Act. It called the dividend an “interim bonus dividend.” Perhaps the term “bonus” was meant to tell shareholders that this is something that they should not expect on a regular basis. In any case, at exactly the same time, the company announced a non-renewable rights issue raising almost exactly the same amount. So, what it gave it took back immediately. In 2011, it made a bonus issue of shares, but paid no cash dividends. Bonus share issues, like stock splits, are just a means to cut the pie (share capital) into smaller pieces and provide no real benefit to shareholders.

During those five years, the cash balances increased from a somewhat precipitous $2.1 million at the end of 2007 to $57 million at the end of 2011. Retained profits increased from $709 million to $980 million. Hong Fok has the cash to pay dividends to shareholders, and the retained profits available to declare these dividends. But it has consistently chosen not to do so.

It certainly had the cash to pay increasing amounts of remuneration to key executives. During the period, key management salaries increased from $9 million to $12 million – or by around one-third. The company discloses the pay of only the directors and employees who are related to directors and employees. Using the midpoint of these bands, the pay of these seven directors and employees increased from an estimated $6.1 million in 2007 to $11.6 million in 2011, or by around 43 per cent. Further, there were significant interested person transactions (IPTs) in connection and their associates over most of these years. The amounts were $15.4 million, $32.8 million, $8.4 million, and $7.7 million for 2008, 2009, 2010 and 2011 respectively.

Since Hong Fok has consistently chosen not to pay dividends, minority shareholders who want to realize a return on their investment have only one choice – sell their shares.

Hong Fok’s board is made up of seven directors, with four of these seven being executive directors, all of whom are part of the family controlling shareholder. However, Hong Fok does not have a remuneration committee. Since pay to executives is not subject to shareholders’ approval, there is also no check and balance by unrelated shareholders. Further, as directors and employees’ remuneration are not considered IPTs under chapter 9 of the SGX listing rules, the remuneration paid to the related family members are not subject to the safeguards in the IPT rules.

One should also examine the IPT rules in chapter 9 of the SGX rulebook. Currently, chapter 9 uses net tangible assets (NTA) as the benchmark to determine whether an IPT is disclosed or whether it requires shareholders’ approval, with the percentages being 3 per cent and 5 per cent respectively. The use of a single benchmark is, in my view, seriously flawed. It fails to recognize that NTA may vary systematically across industries. In contrast, the Hong Kong Stock Exchange uses five ratios: asset ratio, consideration ratio, profits ratio, revenue ratio, and equity capital ratio. While the trigger points may be higher, the use of different benchmarks provides better indicators of the significance of an IPT. In my view, it is illogical to use NTA for all IPTs.

In judging materiality of a financial statement item, for example, we would not use the same base for all items.

In the Hong Fok case, the IPTs did not constitute transactions requiring announcements or shareholders’ approval because the percentages relative to NTA are low. The total IPTs relative to NTA ranged from less than one per cent to around 4 per cent. However, if we were to express the total IPTs relative to revenue, a completely different picture emerges, with the percentages ranging from 6 to 60 per cent. If we add in remuneration of related employees, the percentages relative to revenues ranged from 14 per cent to almost 80 per cent.

In enhancing our corporate governance rules and guidelines, regulators should benchmark to international norms. However, they also need to recognize that these norms are somewhat contextual and may be more applicable in countries with different shareholding structures and institutional environments, including the level of concentration of ownership and the preponderance of institutional versus retail shareholders. We need to be more innovative when enhancing our rules and guidelines, and balance the need to benchmark against international norms and the need to address country-specific issues.

In my view, our current rules on executive remuneration and interested person transactions are grossly inadequate for protecting the interests of minority shareholders. Hong Fok has fully complied with the letter of these rules, but that provides no comfort to minority shareholders.

More benchmarks needed: The Hong Kong Stock Exchange uses five ratios. The use of different benchmarks provides better indicators of the significance of an IPT.

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