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Flash Commentary: Corporate Governance

Four Questions for Alphabet

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Google's impending restructuring into a holding company called Alphabet doesn't change the underlying business so much as make explicit the company's dual-track nature. On one track, Google has a mature search/advertising business; on the other, an investment company with a focus on speculative technology investments and basic research. The new structure, intended to provide transparency to investors about the relative performance of each side of the business, will be welcomed by investors.

However, the separation of businesses also clarifies the underlying concerns some investors have expressed about the company's corporate governance, and may amplify the typical investment concerns associated with conglomerates. Shareholders may question whether the allocation of capital to basic research projects is the best use of shareholder resources, or whether some of the non-core businesses are consistent with the risk profile of Google's investors. Shareholders may also wonder whether management is competent to manage these diverse enterprises. The company's unequal voting structure, which allows insiders to control the company, limits meaningful shareholder input into these decisions. Analysts and governance advocates have frequently called for Google to adopt a one-share-one vote structure.

However desirable greater shareholder democracy would be from an investor perspective, it is unlikely to emerge at Alphabet. The founders' vision of the company was always less about search and advertising and more about "the business of starting new things," to quote Larry Page's announcement. Given investors' time horizons and risk profiles, the unequal voting structure is the only way to maintain this core vision.

From a governance perspective, it is probably more useful to view Alphabet less as a public company than a public-private company hybrid, where the function of the public business is to provide returns to shareholders net of ongoing investments in the private company.

Traditional corporate governance thinking assumes that a company cannot "serve two masters," in this case cash generation and a speculative investment strategy. Corporate governance questions need to address how the company will maintain discipline and give appropriate transparency about its progress on all its goals.

What is the role of the board and group management team?

Most conglomerates fail because the top level of management is redundant, adding neither value to investors' asset allocation decisions nor to the management of underlying businesses. The relatively few successful conglomerates do one or the other well: either, like Berkshire Hathaway, they are pure investment companies whose management is skilled at asset allocation and gives individual businesses wide strategic latitude while engaging in careful oversight; or like General Electric, whose core competency has historically been the ability to manage diverse businesses.

Alphabet's portfolio of companies is highly diversified, but each business is also dependent on Google's core competency of gathering and using massive amounts of data. Therefore, it seems unlikely that either traditional operating model will be ideally suited to Alphabet. Individual businesses will need both autonomy and the ability to cooperate to optimize the use of this shared resource.

Shareholders will need a better understanding of how the board and management view their roles in acquiring, coordinating and overseeing the operating companies, and how power will be shared between the operating companies and the group management team. Moreover, because the group will serve as a layer of management between investors and the underlying businesses, clear disclosures about how these businesses are being evaluated will be important to shareholders.

How can the independent directors' role be strengthened?

An important risk in the public-private hybrid is a potential lack of discipline arising from the focus on multiple sets of corporate objectives. For example, the appropriate allocation between dividend policy and new acquisitions is challenging at any company, but especially at one where the acquisitions may not generate returns until far in the future, if at all. The role of independent board members in maintaining corporate strategy and discipline is particularly important. Here are a couple of suggestions:

- In the absence of meaningful independent shareholder voting power, the power of independent directors to serve as a check on management becomes increasingly important. (Legacy) Google does not have an independent Chair (Eric Schmidt is the former CEO) but it does have a lead independent director. However, the power of this position could be strengthened to give shareholders confidence that there is some independent check on management decision-making.
- Under the new company, the board's Acquisition Committee may take on greater significance. However, the membership of the Acquisition Committee comprises the two founders plus the non-independent board chair, with no

independent members. Shareholders will want to know more about how the independent directors can exert influence over the acquisition strategy of the company.

Can the company articulate a social mission and objectives?

Many of Google's ventures, including Calico (longevity), Sidewalk (Smart Cities) and Google X (driverless cars) will have difficulty setting financial objectives in a time horizon meaningful to investors. However, the promised long-term social benefits of these projects are more clearly articulated. Over the long term, meeting traditional financial goals will depend upon delivering on this promise of social benefit. The firm's progress toward achieving these goals will be an important consideration for shareholders. The company should integrate both social objectives and metrics for each of its non-core businesses into its financial disclosures. The company should also integrate an overall social vision to guide these acquisitions into disclosures of its corporate strategy.

Does executive compensation create the right incentives?

According to company filings, over 90% of shareholders supported the company's executive compensation plan at the 2014 annual meeting. However, assuming that insiders, whose non-public "B" shares confer voting power disproportionate to their ownership stake, support the plan nearly unanimously, the vote could signal underlying discontent among external shareholders. While it is not possible to know how publicly traded "A" shares were voted, our back-of-the-envelope calculation suggests that approximately 25% of external investors voted against the compensation plan, which should raise concerns about the plan, since investors are usually reluctant to vote against plans at high-performing companies.

By establishing incentives to drive executive behavior, compensation plans provide the clearest signal of board strategy and priorities. Particularly for a company like Alphabet, executive compensation disclosures provide an opportunity to explain how the company intends to implement multiple strategies. Moreover, shareholders will be interested not only in compensation for the most senior executives but also for CEOs of the operating companies. Questions about compensation may include: In the absence of clear financial metrics, how will executives be judged on the success of acquisitions? How will social and financial goals be balanced? What financial metrics are appropriate given the company's strategy?

Alphabet is not a traditional company and is unlikely to adopt traditional corporate governance. In our view, its disclosures need to explain how its unconventional structure will serve decidedly conventional investors.

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Public companies mentioned in this report:
Berkshire Hathaway (BRK-A, $215,300)
General Electric (GE, $26.24)
Google (GOOG, $633.73)