# Ripe For the Picking

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## Cannabis sector governance needs to catch up to share price

With new shareholders, increased scrutiny of investors, and a growing list of possible buyers (friendly or otherwise), the decisions made by cannabis company directors in the next few months could decide their fate.

*Will your company go up in smoke?*

As CanniMed Therapeutics learned in its hostile bid defense against Aurora Cannabis, companies should not only be on the lookout for hostile bidders, but also for activist shareholders able and willing to elect directors who are out of step with the current thinking and strategy of the company — directors who can act as catalysts for unwelcome change.

Boards need to prepare themselves for a shareholder-led campaign for change and a Trojan horse approach that could put activists in the boardroom.

Often the thin edge of the wedge used to drive these changes is a concern over governance. If you are an executive or director in the cannabis space you need to ask yourself if you have someone facilitating and monitoring this years' AGM vote. If the answer is 'no', then you might be in for some trouble.

## A changing landscape

With rising share prices and a rosy outlook, the temptation for directors to be complacent to outside threats –from hostile bidders or activist shareholders– is strong.

In meteoric fashion, some of the now-large cannabis companies have graduated from the TSXV to the TSX, and in some cases the S&P/TSX Composite Index. While this has created huge returns for seed investors, it has also dramatically changed shareholder bases: large cannabis companies have started to see a turnover from retail to institutional investors. A shift driven by impending legalization, the need for capital for things like greenhouses and acquisitions, and the fact an increased market cap and indexing makes them eligible institutional investments.

A recent example of this was Canopy's $175 million bought deal led by BMO Capital Markets and GMP Securities. In fact, our analysis of the major companies in the cannabis space shows a considerable increase in the number of institutional shareholders: in some companies, institutional ownership has increased threefold.

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## Welcome to your new reality

For cannabis companies, this presents a whole new paradigm: Firstly, institutional investors place more scrutiny on companies for things like governance — something that is invariably an afterthought for most retail shareholders.

And, importantly, proxy advisory firms Institutional Shareholder Services and Glass Lewis—firms tasked with providing vote recommendations on proxy items—will now have a say in shaping the future of a company by means of their proxy vote recommendations.

While the changing landscape poses several challenges for cannabis companies, there are several proactive measures that boards can take to prepare themselves.

## Know your shareholders

Share volatility means that companies will have a tough time keeping track of who their shareholders are.

Annual meeting 'season' presents an excellent opportunity to identify and engage your new shareholder base. Not only is it important to use the solicitation process to reach out to shareholders, but to also understand the voting policies and practices of institutional investors. Companies are encouraged to develop detailed institutional profiles that include voting procedures, governance knowledge, patterns and flexibility to change their votes.

Time and time again we have observed a strong correlation between the relationship a board has with its shareholders and the likelihood of success when faced with adversity: the more frequent and closer the contact, the greater the chance of success.

## Set up your defences

As consolidation activities continue, cannabis companies should be thinking about whether their defense mechanisms are up to date. Adopting a proxy advisor compliant advance notice by-law and a "new generation" shareholder rights plan is a good start to preempt an unwarranted activist attack. Significantly, these are two steps endorsed by ISS.

As seen in the Aurora/CanniMed takeover deal, over one-third of CanniMed shareholders were subject to hard lockup agreements pursuant to Aurora's hostile bid. This significantly jeopardized CanniMed's acquisition of Newstrike Resources as the termination of the Newstrike acquisition by CanniMed was a condition of the Aurora bid. Had CanniMed had a shareholder rights plan in place prior to the launch of Aurora's hostile bid, the hard lockup agreements would have been prevented.

This also demonstrates the importance and benefits of why outside advisors should be engaged early.

## Independent leadership on the board is Governance 101

The board structures of Canadian cannabis companies are lagging when it comes to independence: average board independence at the largest cannabis companies (market cap of more than $1 billion under the Canadian Marijuana Index) as of their 2017 AGM was only 66 per cent with 60 per cent of the companies having a combined CEO/Chairman role.

Improving the independence level of boards can simply be achieved by adding more independent directors. Good directors do not necessarily need to be in the sector, but should provide a diversified skill set on a range of topics such as capital markets, risk management, and legal and corporate governance.

## Strong link for pay for performance

Good corporate governance demands a sophisticated and robust pay-for-performance compensation structure tying executive pay to both the short and long-term objectives of the company.

The purpose of long-term incentives is to reward executives for achievement of the company's strategic objectives that will maximize shareholder value. Our scan of the industry, however, confirms that long-term incentives are generally absent from executive pay packages.

For example, one of the largest players in the sector — now included in the S&P/TSX Composite Index —had its CEO's compensation, as of their 2017 AGM, composed of only a base salary, bonus, options, and 'other' compensation. This structure lacks a crucial element – long-term performance based equity compensation that has been endorsed by proxy advisors and credible institutional investors.

Selecting a Performance Share Unit (PSU) peer group and setting up relative total-shareholder-return target thresholds are important first steps. What's more challenging, however, is designing a systematic and objective scorecard approach for the Short-term Incentive Plan, and incorporating long-term financial or operational goals for the PSUs. Setting appropriate target criteria will require some deeper thinking due to the expected high volatility and significant exogenous factor influence in the sector.

Lastly, it is worth noting that among the largest Canadian cannabis companies, only one had a standing say on pay vote as of their 2017 AGM. Say on pay votes give shareholders a chance to vote on executive pay, can help shield compensation committee members from shareholder challenges — at least for the first year — and is a sign of good corporate governance.

## Lack of gender diversity will not be excused

40 per cent of the largest Canadian cannabis companies did not have a female director on the board as of their 2017 AGM; smaller cannabis company boards have even less female representation.

Both ISS and Glass Lewis have introduced new gender diversity policies that may impact TSX issuers.

ISS now has a double-trigger gender diversity policy in place which could result in withhold votes from the chair of the nominating committee if a) the company has not disclosed a formal and robust written gender diversity policy and b) there are no female directors on the board.

'Robust', as defined by ISS, means that the board's gender diversity policy needs to include "measurable goals and/or targets denoting a firm commitment to increasing board gender diversity within a reasonable period of time." ISS' new gender diversity policy is applicable to S&P/TSX Composite companies in 2018 and all TSX companies in 2019.

Similarly, Glass Lewis has introduced a single-trigger gender diversity policy of which it will generally recommend withholding from the chair of the nominating committee if the company has not adopted a formal written gender diversity policy <u>or</u> there are no female directors on the board. The new Glass Lewis gender diversity policy will be applicable to all TSX companies in 2019.

Many institutional investors have also adopted similar or stricter policies that may not be as apparent to a company until their vote results start coming in.

## Remember skin in the game matters

If executive officers are cashing out or taking some profit off the table, no red flags will be raised as long as they still have a meaningful share ownership position in the company. But management and boards should keep in mind that a large disposition of shares can be seen as an indication of a lack of confidence in the future direction of the company.

Proxy advisors don’t take a hard line on this and cannot simply recommend withholding from directors just because they have been decreasing their shareholding position. (Of course, NEOs and directors must meet minimum share ownership guidelines.)

The good news is that in the cannabis sector – compared to other sectors such as energy and resources – most CEOs and directors hold considerably more shares even after the recent share sales spurred by a spike in the market.

Like it or not, as Canadians and shareholders acclimatize to the legalization of a previously controversial industry, those operating within the industry need to be beyond reproach. Going above and beyond in terms of corporate governance will be critical to bridging the credibility gap in a new industry and live up to what institutional investors have come to expect of high investment grade companies.

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