Viewpoints

What is the business case for diversity on boards?

Let the numbers speak for themselves!

By Shai Ganu

Companies with more diverse boards tend to have stronger financial performance. A 2019 Willis Towers Watson study of top 100 listed companies in Singapore, over the past three years, suggests a strong relationship between the following board diversity attributes and company financial performance.

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Diversity on boards and management teams is increasingly, and deservedly gaining prominence in Singapore. Organisations such as the newly established Council for Board Diversity and Singapore Institute of Directors' Diversity Committee are championing more diverse representation on boards across public, private, and charity sectors. Their tireless efforts have resulted in a considerable improvement in the number of female non-executive directors (NEDs) within the top 100 companies[1] listed on the Singapore Exchange (SGX), growing from 7.5 percent in 2013 to 15.2 percent in 2018. However, there is still a long way to go in achieving the stated targets of 20 percent by 2020, and 30 percent by 2030[2].

Board diversity is often viewed as a societal issue. Half of our society and half of our workforce are women, so it makes sense that the board and management teams should also have stronger representation of women. Enlightened companies and board chair view gender diversity as something more than a societal issue – they see it as the right business decision as well. These companies understand that women directors bring different skills, attributes and stewardship styles to the board, which ultimately enhances its effectiveness.

We should also understand that gender is just one dimension of diversity. In the context of board diversity, it will be meaningful to expand the definition of diversity to cover board's independence, as well as age, tenure, ethnicity, and domain expertise.

Willis Towers Watson recently conducted a research to assess the importance of board diversity and business performance of companies in Singapore. Through empirical analysis, we found that companies with more diverse boards generate stronger business results.

Board diversity leads to stronger business results

Our hypothesis was that companies with a diverse board are higher performing financially than companies without a broadly diverse board. Having NEDs with a diverse mix of skills, experiences, and expertise ensure that probing questioning, constructive criticism, and challenging debate can take place. The resulting decisions will be based on varied perspectives, and in turn, will have higher success rates.

[1] Universe of 120 companies, less some exclusions for unusual ownership structures or dual-listing status.

[2] Source: Council for Board Diversity. "Top 100 SGX-listed companies doubled women's participation on boards, achieving 15.2% from 7.5% before DAC was formed." Dec. 2018, http://www.diversityaction.sg/statistics/as-at-dec-2018/.

[3] Given the challenges in establishing casualty based on public domain data, we examined the correlations.

We analysed the top 100 SGX listed companies, and tested the relationship between board diversity, and the companies' latest three year financial performance[3] measured as revenue growth, profit growth, company valuation measured as price to earnings ratios (P/E), return on equity (ROE), economic value add (EVA), and total shareholders returns (TSR).

1. Independence

Boards with a majority of independent directors should have unbiased decision-making aligned with shareholders' interests. Independent board members can bring external expertise which can reduce agency costs and help improve performance. However, they may also operate at an information disadvantage and may lack institutional history, thus limiting their effectiveness.

Consequently, our hypothesis was that there ought to be a positive relationship between a board, where the majority of its members are independent, and company performance. Based on our study, companies which had a board with 75 to 90 percent independent directors tended to have the strongest performance than those with fewer independent directors. At less than 10 percent of the overall sample, these companies had higher TSR, ROE, P/E ratios, and EVA performance than those with fewer independent directors.

75%+ independent NEDs

- Higher valuation - **23%** P/E multiple
- **2 times** higher TSR
- **19%** higher ROE
- **90th** percentile EVA spread

This corroborates the principle that boards with the optimal balance between independent and non-independent representation are likely to outperform all others.

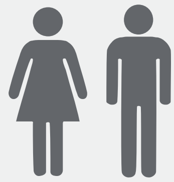
2. Gender

Women often bring different competencies and approaches to stewardship, different risk-reward orientations, and consequently may provide more balanced perspectives to decision-making. Female board members may also be able to represent the views of the wider employee base, and hence lead to enhanced understanding of broader customer preferences.

Nearly a third of the companies in our study had no women directors. Companies with at least one female on the board out-performed in terms of TSR, ROE, and revenue growth. Companies with two or more female directors also out-performed those with no female directors, but did not see a material upside compared to those with one female director. Boards with two or more female directors were valued at a premium (i.e. higher P/E ratios).

One or more women on the board

- **10 times** higher TSR
- **42%** higher ROE
- **18%** higher revenue growth
- **12%** P/E premium for 2+ female NEDs compared to 1 female NED



This supports the hypothesis that companies with at least one female director have stronger business performance.

3. Age

The 2018 revision of Singapore's code of corporate governance (Code), for the first time, called out age as an important attribute of board diversity. The premise is that directors of different age groups bring different life experiences and perspectives to the board, enhancing its decision-making effectiveness.

20+ years age differential among NEDs

- **4 times** higher revenue growth
- **5%** higher ROE
- **4%** higher P/E multiple
- **10%** P/E premium for age spread greater than 35 years

Our analysis shows that only around 2 percent of NEDS within the top 100 Singapore listed companies are below the age of 40 years old, and around 2 percent are above the age of 80. However, our study revealed that the age of directors did not have any have any material correlation to company performance. Instead, there was a strong relationship between company performance and age differential among board members.

Companies with at least one generation difference, with between 20 and 35 years separating the youngest and oldest director tended to outperform in terms of ROE, P/E ratio, and revenue growth.

This emphasises the importance of younger directors who can bring fresh ideas, as well as older directors who often offer a wealth of experience.

4. Tenure

Routine turnover and board refresh is necessary to introduce new ideas, experiences and to keep up with the dynamic needs of the business. This is particularly relevant in Singapore, where the revised Code sets a nine-year term limit beyond which a director may not be considered independent.

Board tenure spread of 8+ years

- **50%** higher TSR
- **60%** higher revenue growth
- **90th** percentile EVA spread

We analysed the correlations between different average NED tenures and company performance, and the findings were inconclusive. However, similar to findings for age diversity, our research shows that companies with a tenure spread of more than eight years exhibited higher TSR, EVA, and revenue growth.

This supports the principle that having board members with varying lengths of tenure provides diverse perspectives, and a healthy balance between fresh ideas and institutional knowledge, presumably leading to more measured decision making, and consequently stronger company performance.

5. Ethnicity

Greater ethnic diversity on boards should bring stronger inclusiveness, creativity, and acceptance to innovative ideas, which may improve strategic decision making. And similar to gender diversity, ethnic diversity may allow the board to better understand and consider the company's employees and customers. The hypothesis is that an increase in the number of ethnic minorities may lower barriers to interaction, allowing for a wider range of skills and perspectives to be shared. To this effect, we tested whether a higher proportion of ethnic-minority board members would result in better company performance.

More than one ethnicity represented on board

- **10%** higher P/E multiple

Our analysis suggests that approximately two-thirds of the top 100 companies do not have ethnic diversity on the board and are culturally homogeneous. However, there is no conclusive evidence to suggest that culturally, diverse boards result in stronger financial performance. It is interesting to note though, companies with ethnically diverse boards had an approximately 10 percent higher P/E multiple.

This shows a positive relationship between ethnic diversity in the board and firm's reputation, and in turn, its valuation.

6. Domain expertise

One of the more important traits of diversity is the variety of domain expertise of board members. A majority of the board members in Singapore tend to have accounting, audit, legal, or commercial (i.e. profit and loss management) backgrounds. However, our hypothesis was that a broader range of expertise (e.g. technology, risk, human capital, organisational development, marketing and public relations) would provide more domain knowledge to the board's decision making, leading to stronger company performance.

4+ skills and functional experiences

- **46%** higher TSR
- **28%** higher ROE
- **11%** higher P/E multiple
- **22%** higher revenue growth
- **27%** higher P/E multiple for companies with 5+ skills represented on boards

Our analysis suggests that only 20 percent of NEDs within the top 100 companies had experience other than accounting, legal, or commercial. The findings reveal that companies with directors that have at least four different areas of domain expertise perform better in terms of TSR, ROE, P/E ratio, EVA, and revenue growth. Interestingly, companies which had 5 or more functional skills represented within their NEDs saw a 28 percent higher valuation premium.

This highlights that companies with directors who have multiple functional disciplines and are able to provide varied domain expertise to the board's proceedings will see stronger performance.

Achieving the ideal state of board diversity

The analysis of the top 100 Singapore listed companies illustrates a strong relationship between board diversity and company performance. Nomination committees should critically review their board compositions and work towards achieving more diverse representation on boards, such that:

- A majority of directors should be independent, balanced by at least one non-independent director (usually the CEO and the managing director).
- There should be at least one female NED, but ideally two or more – and eventually there should be equal representation.
- At least one director should be below the age of 40 or 45 years old to provide a generational difference between the youngest and oldest director.

- Boards should have a strong spread of tenures with eight years or more between the newest and oldest serving board member, even if that means that some directors exceed the nine year rule and may no longer be deemed independent.
- At least one board member should come from a cultural minority.
- Directors should represent at least four different functional expertise areas such as audit and accountancy, legal backgrounds, human resources, risk management, and technology.

It is important for companies in Singapore to challenge the traditional ways of sourcing directors (i.e. through personal networks), and focus on acquiring skills, experiences, and a diversity of thought. Boards may fail tomorrow, if they fail to change today. Progressive companies are beginning to appreciate the importance of diversity, and have tailored their nomination and appointment priorities accordingly.

In a diverse society, a diverse board can provide multiple perspectives, helping increased social acceptability, and in turn ensure that the board conducts itself appropriately. It is critical for boards to ensure they have diversity of experience, background and thought.

Indeed, the numbers speak for themselves – the business case for board diversity is irrefutable.

*A version of this article appeared in The Singapore Business Times on June 7, 2019.

About the study

Willis Towers Watson Singapore's Executive Compensation and Corporate Governance Advisory team conducted a study of top 100 SGX listed companies for the past three years to examine correlations between board diversity attributes (i.e. board independence, gender, age, ethnicity, tenure, and domain expertise), with three-year financial performance (measured as revenue growth, price to earnings ratio, return on equity, economic value add spreads, and total shareholders returns). Given the challenges in establishing casualty based on public domain data, we examined the correlations. The study was conducted in 2019, using publicly available company information.

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