HERMES EQUITY OWNERSHIP SERVICES LIMITED

ENGAGEMENT CASE STUDY: PREMIER OIL
Engagement focus: shareholder value, governance, and social issues

Background

By late 2000, Premier Oil had become a cause celebre amongst those concerned with governance and more particularly with the social, ethical and environmental responsibilities of business.

Its share price was languishing, and it appeared unable to deliver on its stated strategy. Working with the company, with other shareholders, and with NGOs, Hermes helped the company to resolve these issues.

Hermes accelerated its engagement with Premier Oil in mid 2000. For several years previously Hermes had communicated its concerns over the company's board structure and had voted against the re-election of several of the non-executive directors whom we did not regard as being independent. On the governance side, the fundamental problem was that the company was dominated by two major shareholders, Amerada Hess, a US company, and Petronas, the Malaysian National Oil Company, each of which held 25% of the shares. Not content with the control and influence they wielded as such major shareholders, each of them also had two non-executive directors on the board. We also deemed two further NEDs not to be fully independent.

These board problems were reflected in an apparent failure by the company to address some of the severe problems that Premier was facing. There was no strategy that was clear to shareholders: it appeared that the strategy proposed in November 1999 when Petronas invested in the company was not being followed, and it was not apparent to investors that an alternative had been developed. The company was in a strategic hole: it was not large enough to compete in production and downstream work with the emerging super-major oil companies, but it was also not as lightweight and fleet-of-foot as it needed to be able fully to exploit the exploration opportunities opened up by the super-major's focus on larger-scale fields.

In addition, the company had allowed itself to become exposed to major ethical and reputational risks as a result of being the lead investor in the Yetagun gas field in Myanmar. Myanmar, formerly known as Burma, was a country ruled by a military dictatorship which had refused to accept the results of democratic elections in 1990, where summary arrest, forced labour, and torture where widely reported, and which had therefore become a pariah state. Premier's involvement in the country had brought public criticism of the company from a range of sources including Burmese campaigners, Amnesty International, trade union groups and, not least, the UK government. It was not clear to us as shareholders that the company was effectively managing the reputational and ethical risks it faced as a result of its involvement in Myanmar.

To begin exploring these concerns, we held a meeting in mid-2000 with Dr Richard Jones, Premier's corporate responsibility director, and the company's finance director John van der Welle. This was an opportunity for us to understand Premier's considerable positive work on the ground in Myanmar – which included building schools, funding teachers, AIDS education and environmental remediation. While we recognised that positive work, we had continuing concerns. The board had not publicly stated that it believed it was effectively managing all the risks that were associated with its presence in Myanmar, and nor did we have the confidence that the board as currently constituted could give shareholders the reassurance that they needed in that regard.

When we had analysed all these issues, it came as no surprise to us that, in the absence of a clear strategy, with the lightning rod of its involvement in Myanmar not being clearly managed and a board which did not seem designed to address these issues in the interests of all shareholders, that Premier's share price had underperformed the market for several years.

Selecting Premier Oil for engagement

With the combination of these issues, governance, strategic, ethical and share price underperformance, Premier Oil was a natural choice for our first year's selection of companies for a Core Shareholder Programme. As a fund manager with predominantly index-tracking mandates, Hermes believes it is in our clients' interest to become closely involved with companies where we perceive there to be problems. In a sense, these actions are simply putting into effect the stewardship which our clients, as partial owners, should exercise over investee companies. Hermes has a tradition of intervention at underperforming companies but the 2000 Core Shareholder Programme (CSP) was our first attempt to establish a more formal and structured basis for determining where we should intervene. Those companies where we had consistently voted against re-elections of directors but had not seen any sign of reform, and where share price performance remained poor, formed the basis of the ten stocks chosen for the first year of the CSP. Premier Oil was among these.

As we did with the other CSP companies, we wrote to the chairman of Premier, Sir David John, requesting a meeting to discuss the full range of our concerns.

While we were awaiting that meeting, Hermes was approached by two separate groups asking it to engage on the SEE issues raised by Premier. The first group was our clients, principally lead by trade union pension fund trustees. The second was from other NGOs who were focusing on disinvestment from Myanmar/Burma. It is worth considering Hermes position relative to these two groups.

As regards the trade unions, Hermes believes it is appropriate that they, as client trustee representatives, should take a keen interest in the stewardship of their investment, including investee companies' response to SEE issues. We were invited by Brendan Barber of the TUC to address the international body which co-ordinates trade union/shareholder campaigns. At that meeting we explained that Hermes could not support trade union campaigns based on a "special interest". We would however be happy to engage where failure to address SEE issues was as the result of poor governance, and where we feared that it threatened long-term shareholder value. Premier was one such case.

The second group who encouraged us to take action were the NGOs.

We were invited to a meeting organised by other fund managers with representatives from the Burma Campaign UK and Amnesty International. Alongside the UK fund managers with strong ethical investment mandates, a US-based investor with a reputation for activism on social, environmental and ethical matters was represented at this meeting.

We were somewhat surprised to find that the purpose of the meeting was to discuss proposing a shareholder resolution criticising Premier for its involvement in Myanmar, something which most at the meeting seemed willing to countenance, despite the fact that they had yet to meet the directors of the company to discuss this proposed plan of action. In any case, Hermes (by reason of our passive, index tracking mandates) was the only fund manager around the table that held a substantial stake in Premier Oil; indeed most held no shares at all.

At the meeting we took what we felt was the responsible attitude of a part-owner of the Premier Oil business. We argued against the proposing of any immediate shareholder resolution, pointing out that there were much better ways to raise issues with the board which would not of themselves inspire confrontation. We volunteered to lead the engagement.

The meeting did provide us with the opportunity to make contact with some of the NGOs active in Myanmar and among the Burmese people. Notably, we began regular discussions with the Burma Campaign UK, explaining to them the different courses of action which the company might take. We also continued to hold regular discussions with other interested institutional investors. As part of our due diligence, we also accessed publicly and privately other sources of insight, such as the UK government, academics, consultants, brokers and journalists. This gave us as rounded a view as possible.

Engagement- process and actions

The meeting with Sir David John took place in January 2001, and was a frank and honest one. It was rapidly apparent to us that Sir David understood our concerns. In December, the firm had already added a new, fully independent NED, in the person of Scott Dobbie, chair of Crestco and a director of the Securities and Futures Authority. Sir David assured us that further developments on the governance side were in train. We approved of these developments, but said that we doubted that they would ultimately be adequate to address concerns. Sir David was also willing to discuss our strategic and ethical concerns. Importantly, he agreed to our request personally to meet representatives of the Burma Campaign UK (until that point their contact with the company had only been through Richard Jones).

We followed up this meeting with a detailed and direct letter outlining our concerns and asking Sir David to begin addressing them in the interests of all shareholders. Sir David's prompt response assured us that the board would continue to work for a solution to "enable the true value of the company to be reflected in the share price". In March 2001, Premier Oil added another fully independent non-executive. This was Ronald Emerson, a banking executive with extensive experience in Asia, and Malaysia in particular.

At the May AGM, Sir David made a very important public statement with regard to the shareholding structure of the company. It was an acknowledgement that the presence of two 25% shareholders was a burden on the company's share price – a point we had clearly made in our meeting with him – and a statement of intent about seeking a resolution to this problem. He said: "We believe that the current share price remains low relative to the underlying value of the business partly as a result of the concentration of share ownership. The board is continuing to seek ways to reduce the discount on assets for the benefit of all shareholders."

Further positive steps occurred in October 2001. The company began to clarify its strategic position by selling assets in Indonesia and restructuring its position in Pakistan, having gained shareholder authority at an EGM.

Throughout this time we were in close contact with pension funds in the United States who were engaged with Amerada Hess over their shareholding in Premier, and hence their involvement in Myanmar/Burma. We had discussions with them regarding concerns we had about certain of Amerada's statements in relation to Premier and Myanmar. Separate discussions were thus begun privately with Amerada to progress these issues.

Over 2001, we worked with other institutional investors on their proposal for a statement on how our investee companies should deal with any involvement in Myanmar. We argued that this document should follow the language of the guidelines we had developed with other institutional investors, which were later published by the ABI in October 2001. We felt that Myanmar should not be singled out as an issue above all others – while the risks of involvement there are significant, there are other countries and other issues where risks are at a similarly high level – and we were not keen to see companies overburdened with a variety of different disclosure requests on a range of issues. Furthermore, we believed that had we signed up to the sort of document that was being proposed it would have been harder for us to achieve the level of access and open conversations we had achieved at Premier Oil. We therefore dropped out of the discussions on this document. The other institutions persevered and eventually published their statement in December.

Moving matters on

The first year of our engagement had brought some progress but had failed fully to address Premier's fundamental problems. We met Sir David and Charles Jamieson, the CEO, in early 2002. This was an impressively frank meeting, where they were willing to be more open with us about the work they had been undertaking to resolve Premier's problems. Over the years since 1999, they had proposed a number of solutions to the company's strategic impasse, but each had been in some way barred by one or other of the major shareholders. They were, however, confident that both shareholders now had a different attitude and that a resolution in the interests of all investors could now be achieved – though it might take a number of months.

Following this meeting we sent Sir David a forthright letter expressing our concerns at the actions of the major shareholders and putting in writing our offer to lend him our support in the negotiations, should that prove valuable. We formally offered to call on our contacts at global institutions and share with them our concerns that certain of the directors of Premier had not proved themselves to be the friends of minority investors. We hoped that the implication of potential difficulties this might cause for fundraising by companies those directors were involved in could bolster Sir David's hand in negotiations. We also raised again our concerns that public statements by Amerada – that its investment in Premier was somehow ring-fenced from Myanmar and that its directors did not participate in any discussions on the company's involvement in that country – seemed to us to reflect a misunderstanding of UK company law.

The company's preliminary results announcement on March 13 highlighted the positive progress the business was making operationally, but more importantly it detailed the progress being made in relation to the company's fundamental problems. It made clear the roadmap the company was using to solve its problems, talking about shedding mature assets in return for the exit of the major shareholders, and turning itself into a focussed, fleet of foot exploration company once again. The statement read: "We are in specific discussions with our alliance partners on creating a new Premier, better balanced to achieve our objectives. While the restructuring process is complex and involves careful balancing of the interests of all shareholders, we are committed to finding a solution before the end of this year and I am hopeful this will be achieved."

As part of our usual series of financial analysis meetings following preliminary or final announcements, we next met representatives of the company – this time Jamieson and John van der Welle – on March 27. This meeting gave us further encouragement that genuine progress was being made, as they suggested to us that the major shareholders both now clearly understood that any deal that they agreed would have to be approved by independent shareholders without them having the right to vote. Therefore, any deal would have to offer minorities full value to be allowed to proceed. The implication that we took away from this meeting was that negotiations were now on track to reach a resolution.

That resolution was announced in September 2002. Premier oil said that it was to "swap assets for shares" with Petronas taking the Myanmar operation and a share of Premier's Indonesian activities, and Amerada a further segment of the Indonesian interest (in which Premier retained a stake). This was in return for cancelling their 25% shareholdings, and losing their right to appoint NEDs – as well as a substantial cash payment from Petronas. Thus the shareholding and governance issues were resolved in one step. By the same action, Premier reduced its oil and gas production activities and focused on "fleet-of-foot" exploration. And finally it had withdrawn from Myanmar in a way which was fully acceptable to the Burma Campaign Group, other NGOs, and to the UK government.

But most critically, the share price of Premier Oil rose 10% on the announcement. Indeed, news of Premier's change in direction had been anticipated by the market for many months. As a result, Premier Oil's share price doubled (relative to the oil and gas sector) during the period of our engagement, netting an excess return to Hermes clients of over £1 million, and more than 50 times that sum to other minority shareholders.