Argo-Voce: A game of board seats, the season finale

STATE REGULATORS IN ILLINOIS AND VIRGINIA MELT THE IRON THONE

Yesterday morning, activist investor Voce withdrew its nominations for election to Argo's board, citing objections from two state regulators which it alleges were influenced by the (re)insurer's lobbying.

Voce said it had effectively been forced to withdraw its nominations and cease soliciting proxies ahead of this Friday's shareholder meeting, after the Departments of Insurance in Illinois and Virginia revoked their permission for Voce to file its proxy statement.

For its part, Argo framed the news as a tactical retreat from the activist due to "overwhelming" support from shareholders – an allegation sources close to Voce deny.

In a week of bizarre plot twists, this may be the *Deus ex Machinas* to rule them all. At this point, it is not at all clear to us how the insurance regulators perceived Voce's quest for a minority of board seats as a potential change of control that could warrant this intervention.

Our initial take is that this is a win for Argo's management, **at least in the very short term.**

Clearly the risk of an imminent loss of a board seat to a hostile activist has lessened, though this already appeared like an outside chance anyway given the favorable ruling of influential proxy advisory firm ISS.

However, there is a risk the firm could see some blowback from shareholders if they feel the company's lobbying actions with its regulators was akin to appealing to the referee. In an atmosphere of heightened scrutiny of compensation ballot measures at peers, this risk is non-trivial, and this ballot measure may now become the key one to watch for signs of dissent.

Though we're instinctively averse to the cop out of a "plague on both their houses", we do think both sides have made serious tactical errors in the ferocity of their campaigns.

One the one hand, we can have sympathy with Argo for its instinct to circle its wagons given the highly personal nature of the criticisms against long-time CEO Mark Watson. Though we understand a proxy contest is partly a battle for eyeballs and attention (and one we in the media fuel), we personally have little interest in the more sensational elements of it.

First, we're ok with high compensation and lavish perks if they are well disclosed to shareholders and are justified by business performance[1] – and these disclosure issues are simple fix if currently under-reported.

And second, the more salacious allegations have *only served to distract attention from the more serious issues of questionable corporate strategy that has lead to an expense disadvantage to peers and corporate governance questions that we believe deserve serious consideration* – issues the majority of this report is devoted to.

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[1] To be clear, that is we believe it is up to the owners of the business to decide these things – not that we would support these policies *per se*.

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We might even go so far as to say Argo's response to the heightened scrutiny has done more to prove Voce's case than any sensational accusations around corporate jets, lavish housing, and inappropriate sponsorships. In some ways, *for us the "cover up is worse than the crime".*

The board's instinct to circle its wagons, expand its board, and engage in all-out war served only to heighten Voce's criticism of an entrenched relationship with management.

If Voce was so far of the reservation in its allegations, a simple external investigation by a credible independent body would have quickly cleared this up, perhaps with some additional disclosure requirements to close any unintentional lapses.

On the other hand, we think Voce made some serious tactical errors. Its decision to outline a more aggressive restructuring plan that went beyond its initial focus on expenses and corporate governance to include both reserve releases and asset sales seems a huge unforced error.

Though we have no intelligence to confirm our view, we believe this may have had an impact on the perception of the investor held by state regulators. Voce proved itself a savvy media operator in its framing of itself as the good guys standing up to corporate greed. It's more aggressive plan opened the door for it to be framed as just another vicious corporate raider out to screw policyholders for a quick buck.

This is not to say either of these views is true – but simply to point out the hyperbolic rhetoric and caricature used in these types of stand-offs. These caricatures are a natural consequence of the adversarial proxy contest.

Simply put, we think a huge opportunity has been missed for a more serious discussion of corporate governance practices at (re)insurance companies, which in our view have lagged the sector's evolution into a more mature stage of its industry life cycle.

Our view is that Voce's campaign has highlighted some serious corporate governance questions that are not unique to Argo within the (re)insurance space. We spend the rest of this report digging into these corporate governance concerns.

By putting an abrupt end to this contest, the state regulators in Illinois and Virginia have deprived us a serious yard stick on which to measure shareholder dissatisfaction with current corporate governance practices – something that appears evident in recent executive pay votes at Axis, RenRe, and AIG.

In the near term, this campaign will serve as a powerful reinforcement of the long-held idea that highly regulated insurance companies make for poor targets of activism. Some may consider this a win.

But for those looking for to the longer term health of our industry, poor corporate governance will inevitably lead to a higher cost of capital, reduce multiples, and serve as a tax on shareholder returns.

The industry has been given time. It should use it to disrupt itself.

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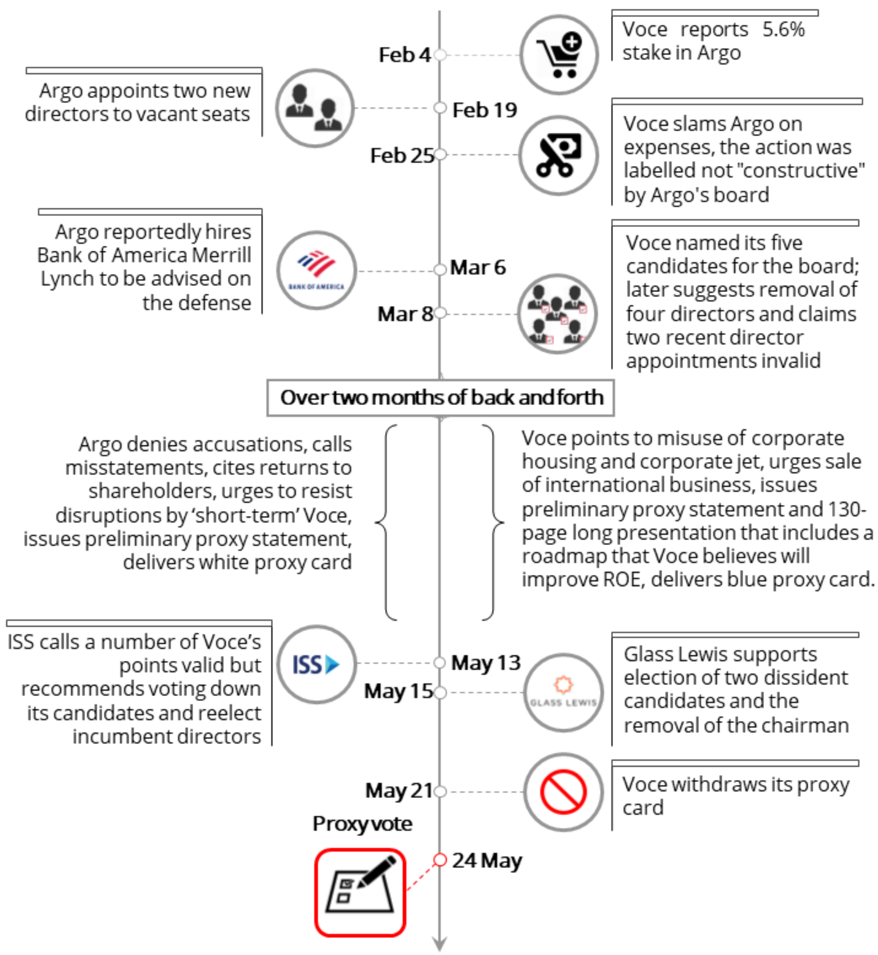
ARGO-VOCE: WHAT YOU MISSED ON LAST WEEK'S EPISODE

Yesterday morning, activist investor Voce withdrew its nominations for election to Argo's board, citing objections from two state regulators which it alleges were influenced by the (re)insurer's lobbying.

Voce said it had effectively been forced to withdraw its nominations to the board and cease soliciting proxies ahead of this Friday's shareholder meeting, after the Departments of Insurance in Illinois and Virginia revoked their permission for Voce to file its proxy statement of 12 April.

For its part, Argo framed the news as a tactical retreat from the activist due to "overwhelming" support from shareholders – an allegation sources close to Voce deny.

The news comes after weeks of elevated rhetoric from both sides in a ferocious and personal proxy contest. We summarise the key events in a timeline below.



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THE BATTLE OF THE PROXIES: WHAT WAS TO BE VOTED ON

Now that Voce has withdrawn its proxy card, only the Argo management's proxy card is to be voted on during the annual meeting on May 24th.

The proposals, including those that dropped out in connection with the Voce proxy withdrawal, can now be generally categorised as follows:

- Re-election of five Class III directors with terms expiring this year and scheduled for re-election by Argo board. Voce is no longer nominating its own director in opposition to one of the incumbent Class III directors.
- Approve Omnibus Incentive Plan.
- Ratify executives' compensation.
- Ratify Ernst & Young as an auditor.
- Proposal by Voce to remove four long-serving incumbent directors **(withdrawn)**.
- Proposal by Voce to elect four new directors to any vacant seats **(withdrawn).**

The recommendations of Argo board and the prior recommendations by the activist, as well as the two proxy firms are presented in the table below.

			Voce			
	Matter	Argo Board	Initial	Post withdrawal	ISS	Glass Lewis
Reelection of incumbent Class III directors	Elect F. Sedgwick Browne	For	Do not vote	Against	For	Do not vote
	Elect Kathleen A. Nealon	For	For	Against	For	For
	Elect Samuel G. Liss	For	For	Against	For	For
	Elect Al-Noor Ramji	For	For	Against	For	For
	Elect John H. Tonelli	For	For	Against	For	For
	Approve 2019 Omnibus Incentive Plan	For	Against	Against	For	For
	Advisory Vote on executive compens.	For	Against	Against	Against	For
	Ratify auditor	For	For	For	For	For
Proposal by Voce of removal of long-serving incumbent directors	Remove Gary V. Woods (withdrawn)	Against	For	-	Against	For
	Remove Hector De Leon (withdrawn)	Against	For	-	Against	Against
	Remove John R. Power, Jr. (withdrawn)	Against	For	-	Against	Against
	Remove Mural R. Josephson (withdrawn)	Against	For	-	Against	Against
Voce caindidates for any vacant seats	Elect Nicholas C. Walsh (withdrawn)	Against	For	-	Against	For
	Elect Carol A. McFate (withdrawn)	Against	For	-	Against	Against
	Elect Kathleen M. Dussault (withdrawn)	Against	For	-	Against	Against
	Elect Bernard C. Bailey (withdrawn)	Against	For	-	Against	Against
Voce candidate in opposition to Sedgwik Browne	Elect Charles H. Dangelo (withdrawn)	Do not vote	For	-	Do not vote	For

Source: Glass Lewis, Institutional Shareholder Services, Inside P&C

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BOARD TENURE ISSUES FLAGGED BY PROXY FIRMS

Now that Voce has withdrawn its proxy card, which automatically drops out proposals on incumbent director removals and dissident election proposals, it may be tempting to believe that the dispute over the firm's board composition is over.

However, given the influx of opinions from ISS and Glass Lewis on the matter, we believe it is likely this will not disappear overnight. We expect Argo will likely face pressure to accelerate the "refreshment" of its board whatever the outcome, something the firm has begun to make pledges around in any case.

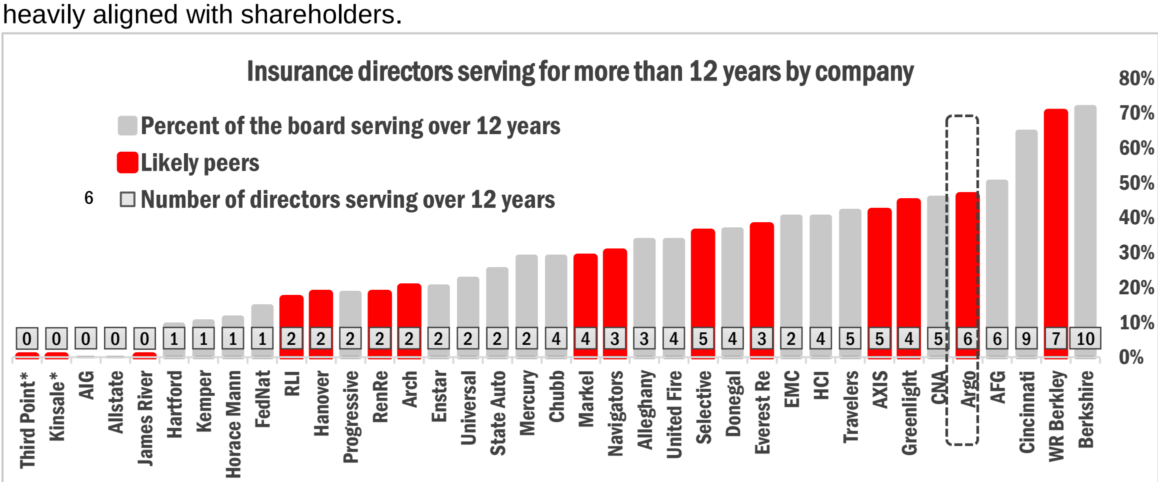
Also, Voce hinted it may attempt to requisition a special general meeting, which could act as another trigger point.

Notably, both ISS and particularly Glass Lewis noted that the board composition that includes six directors with 12-year tenures, all of which had served on the boards of predecessor companies for at least six years, is unreasonable.

Indeed, Argo is in the 80th percentile for the number of directors whose tenures exceed 12 years within the sample of large US and Bermuda P&C (re)insurers.

Only four insurance carriers have larger percentage - AFG, Cincinnati, WR Berkley and Berkshire Hathaway - all of which are at least 3.5 times larger than Argo by market capitalisation, and most likely experiencing closer oversight from the larger base of stakeholders.

More importantly, Berkshire Hathaway, WR Berkley and AFG have strong family ownership which overlaps with board seats, which means the well-tenured members are heavily aligned with shareholders.



Source: S&P Global, Inside P&C

*Kinsale and Third Point Re have been public for less than 12 years

There is more to the board tenure structure problem than just the simple fact that 46 percent of the board consists of long-serving members.

The more far-reaching issue may become the case that the remaining six directors have average tenure of only three years.

As shown in the chart below, Argo's directors with tenures less than 12 years have fourth lowest average tenure within our sample of (re)insurance carriers and a second lowest within the sample of Argo's likely peers.

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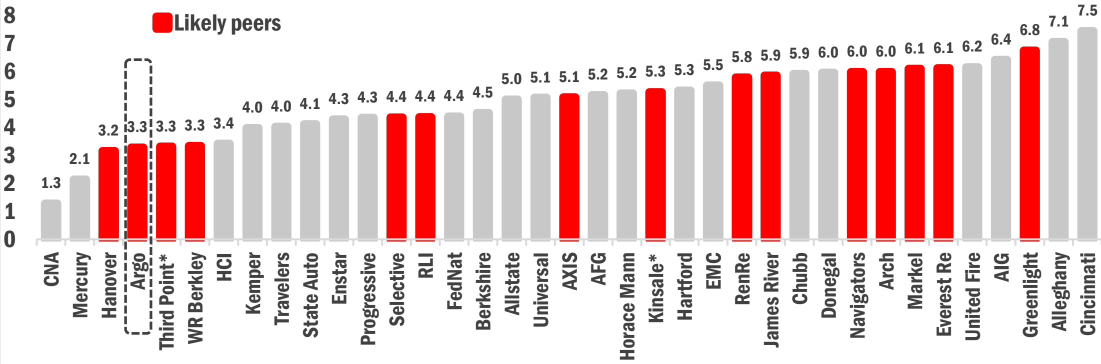
Average tenure of directors serving less than 12 years



Source: S&P Global, Inside P&C

*Kinsale and Third Point Re have been public for less than 12 years

According to corporate governance orthodoxy, such a dual-tier tenure structure creates potential for unwanted subordination, hierarchy and cosy relationships. It can also serve as occurrence of social proof, conservativism and other related biases on the board that may hurt its objectivity and eventually lead to decisions that fall short of shareholders' best interests.

This thesis, it seems, found a confirmation in Glass Lewis's report. The California-based corporate governance services provider concluded that Argo's "entrenched" board is "in need of fresh perspective". Glass Lewis recommended removal of the chairman Gary Woods from the board and approval of dissident nominees Charles Dangelo and Nicholas Walsh.

On the other hand, ISS concluded that the there is no sufficient evidence that rationalises removal of any of the long-serving directors, as well as the need in a dissident's representation in the boardroom.

This was surprising to us for two reasons.

First, between Glass Lewis and ISS, the latter is usually the one who promotes changes to the board.

Second, ISS's report validated a number of the key corporate governance and operational performance issues underscored by the activist, including board tenure, elevated expenses, misaligned executive remuneration, cherry-picking to improve visible performance and failure to engage in a constructive dialogue around issues put forward by the activist (all of which are discussed later in the article).

ISS highlights Argo's unwillingness to discuss common topics, using as an example Argo's references to shareholder returns in response to the various issues raised by the activist. However, ultimately it seems ISS was unable to escape the power of this argument itself.

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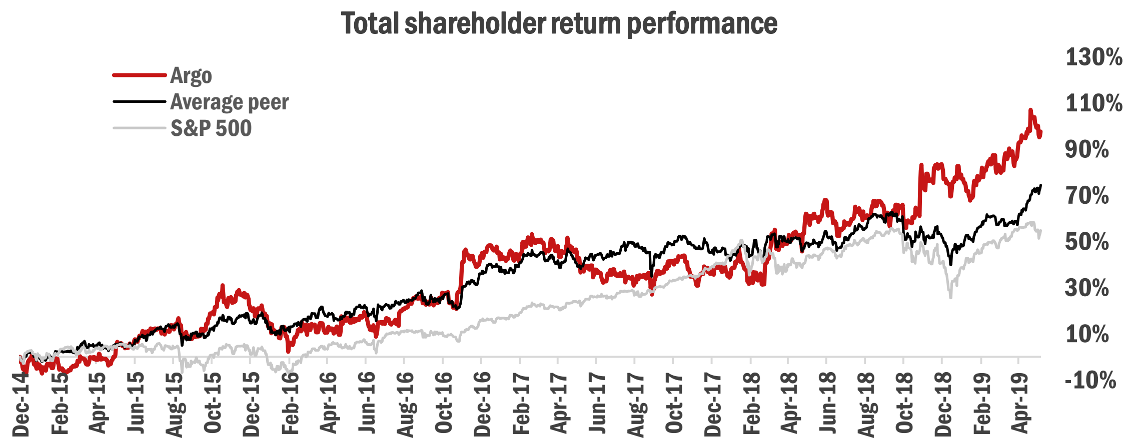
HIGH SHAREHOLDER RETURNS FROM MULTIPLE EXPANSION MASK MORE LACKLUSTRE BUSINESS PERFORMANCE

Argo's line of defence against the activist's criticism was built around its superior total shareholder return. Voce accused Argo of self-selecting poorly performing peers to the peer group to artificially boost its relative performance. The activist asserted that Argo has recently changed the composition of its self-selected peer group and is intentionally omitted its acquired peers, thus exposing the sample to survivorship bias.

The proxy firms' reports have not delved into Argo's peer-selection patterns but made clear that cherry-picking is a potential issue at the Bermudian.

Both ISS and Glass Lewis discussed the total return performance in detail in their reports and confirmed that Argo's total return outperformance using one to five-year horizons, holds largely true regardless of the peer group composition.



Source: S&P Global, Inside P&C

Voce further argued Argo's return performance has largely been propelled by the valuation pickup rather than the actual operational outperformance. In other words, the shareholder returns were driven by the positive expectations about the future performance (including potential M&A given comparable transactions at competitors), which resulted in a higher price-to-book ratio, rather than improved fundamental performance.

To put this in perspective, we calculated total value creation, a conservative performance metric that calculates the growth of tangible book value including the effect of dividends paid.

The metric is unaffected by the price-to-book repricing factor and is deemed the gold standard of performance yardsticks for insurance companies. Notably, Argo's own current long-term executive compensation incentive plan centres on book value per share growth as a primary metric.

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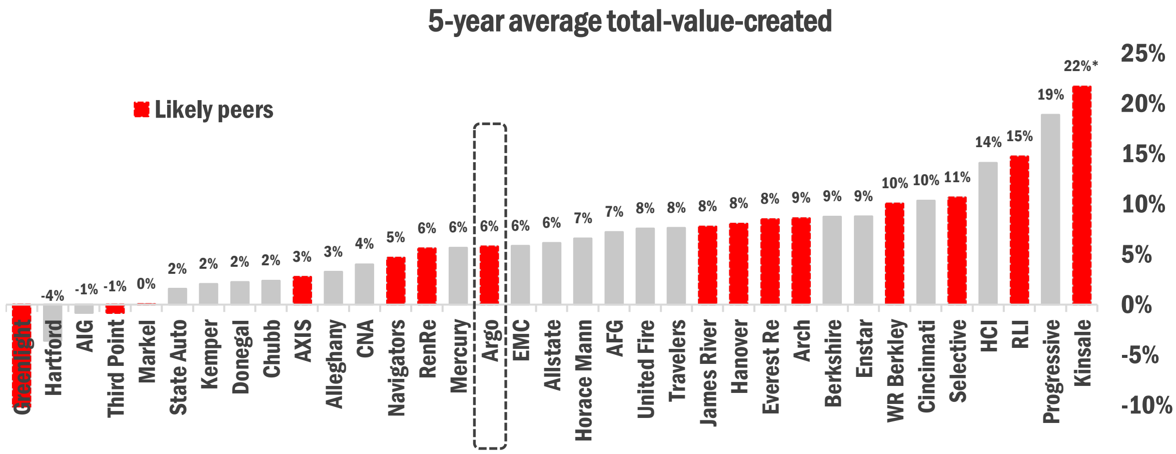


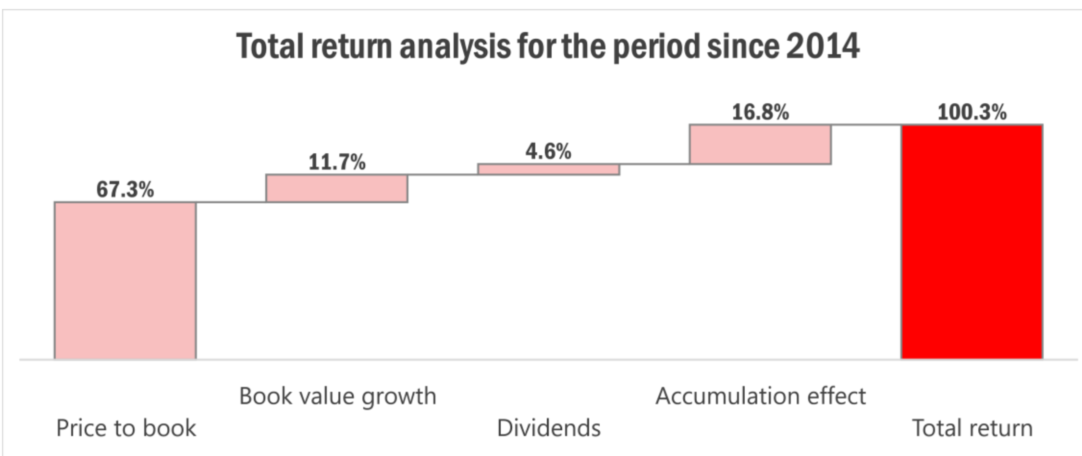
Source: S&P Global, Inside P&C

*4-year average due to limited sample

Argo's 5-year average 5.8 percent and 5-year overall 32.0 percent total-value-created fell slightly below the mean and the median of both its likely peers and our sample of US and Bermuda (re)insurers.

While Glass Lewis has not addressed the valuation aspect in its report, ISS performed analysis on how Argo price-to-book developed relative to the peers and concluded that the firm's recent stock outperformance is largely due to the valuation picking up from the value-destroying 0.7x four years ago to the current ~1.4x, which represents approximately 100 percent upwards repricing.

This may imply Argo's recent outperformance is a catch-up run that is not fuelled as much by business performance as by positive expectations about the future performance or non-fundamental aspects like M&A (something the market is likely to see as more likely with an activist involved).



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REMUNERATION MAY YET RECEIVE INCREASED ATTENTION

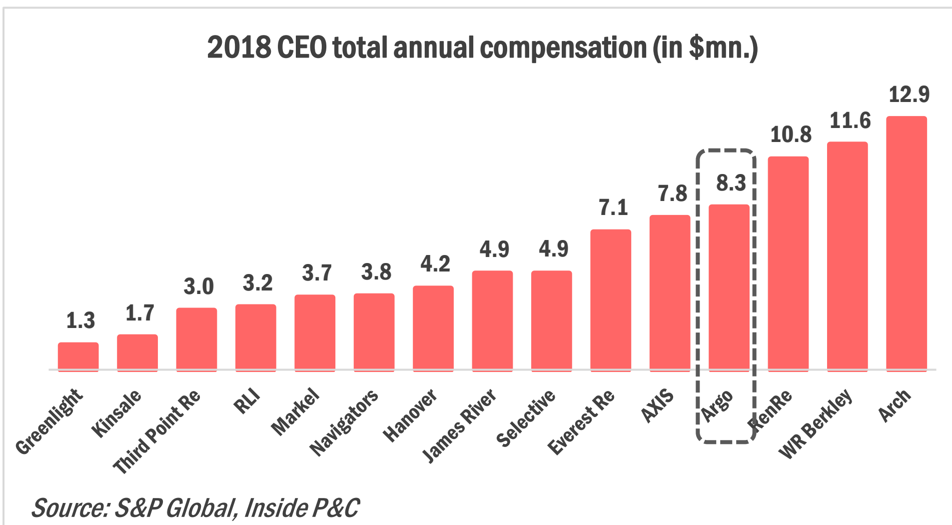
The executive pay measure may now become one of the most closely contested proposals in the upcoming meeting. This seems even more plausible looking at some signs of revolt around executive pays at other insurance carriers.

Earlier in the month, 46 percent of RenRe's shareholders voted against the executive pay measure. Similarly, almost a third of investors voted against the executive pay increase at Axis. On Tuesday this week, AIG also saw dissent over executive pay, with 45 percent votes going against the proposed executive pay.

Notably, ISS recommended to vote down the executive pays on all of the cases discussed above. The firm has recommended the same action for Argo, which will likely see Voce's close to 6% stake voted against the measure.

The proxy firm suggested that Argo CEO Mark Watson's salary is way off industry standards. "The most significant concerns are around the CEO's $4.4 million special long-term performance grant" ISS wrote, and highlighted that the current compensation design may reward CEO for short-term performance versus long-term value-creation.

On the contrary, Glass Lewis made inverse conclusion stating that Argo's executive compensation have historically been well aligned with the performance and recommended to approve the proposal.



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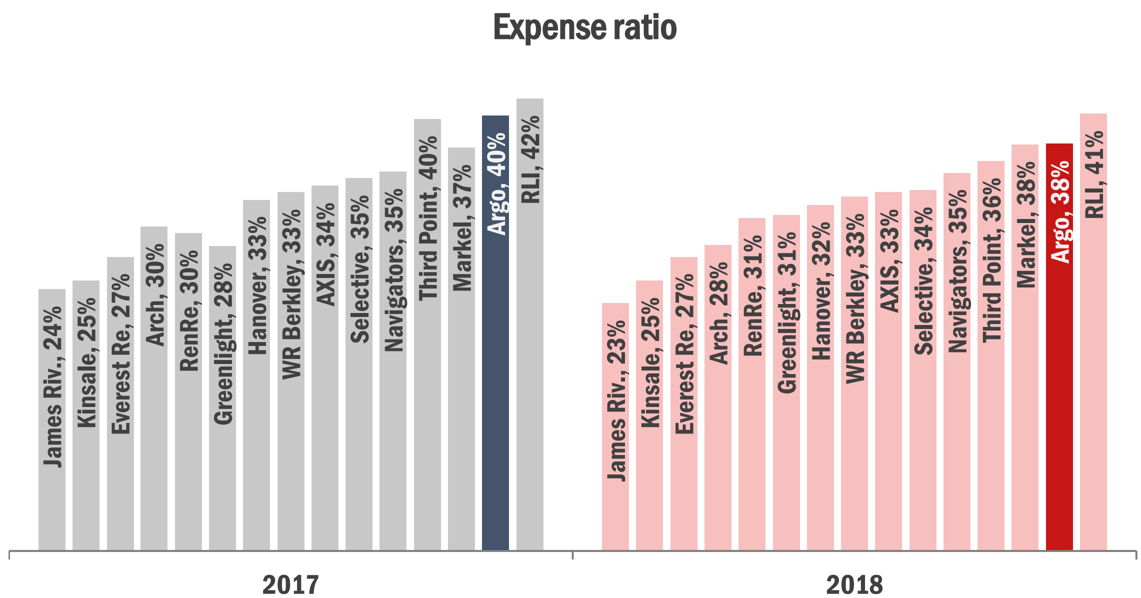
EXPENSES: STILL ARGO'S ACHILLES' HEEL

Voce's plan to promote more rigid expense management was one of the first theses that, along with corporate governance failures, was put forward when the activist first disclosed 5.6 percent stake in Argo.

This has been a longstanding problem for Argo and Voce was not the first critic of the company in this regard. Argo's expense ratio is the second highest among its likely peers, and is an obvious Achilles' heel for the Bermudian.



Source: S&P Global, Company financial statements, The Insurance Insider

Indeed, both ISS and Glass Lewis agreed there is an expense problem at Argo.

The proxy firms seemed supportive of Voce's narrative of elevated expenses at Argo, with ISS emphasising the high expenses relative to the loss ratio and Glass Lewis focusing on investment-related expenses.

However, both proxy firms were rather reticent in backing the activist with regards to the specific cases of corporate assets misuse, such as personal use of corporate property, excessive corporate jet travel, expensive corporate housing, lavish offices and decor, and unnecessary corporate sponsorships.

Glass Lewis's concluded that "the board has provided a generally reasonable defense of its practices and oversight of management" in relation to Voce's accusation on the expenses.

In turn, ISS suggested that Voce's excessive focus on specific examples of lack of corporate expense discipline distracted stakeholders from what is actually important.

"Flashy diatribe against the Argo CEO… did not ultimately substantiate the degree of impropriety implied by its opening salvo" wrote ISS.

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