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Industry expert directors☆

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ABSTRACT

We analyze the valuation effect of board industry experience and channels through which industry experience of outside directors relates to firm value. Our analysis shows that firms with more experienced outside directors are valued at a premium compared to firms with less experienced outside directors. Additional analyses, including a quasi-experimental setting based on director deaths, mitigate endogeneity concerns. The association between having directors with more industry experience and higher firm value is more pronounced for firms with larger investment programs, larger cash reserves, and during crises. In contrast, it is weaker in more dynamic industries, i.e., industries that rank high in terms of sales growth, R&D expenditures, merger activities, competitive threat, and product market changes, where the value of previously acquired experience is likely to be diminished. Overall, our findings are consistent with board industry experience being a valuable corporate governance mechanism.

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1. Introduction

A firm's board of directors is expected to perform the pivotal tasks of monitoring and advising top management. The monitoring function – which is to solve the agency problem created by the separation of ownership and control in modern corporations – has traditionally been at the focus of the empirical corporate governance literature. In a nutshell, this extensive strand of literature finds that smaller, outsider-dominated boards are more effective in monitoring management as they make business decisions with less managerial interference as well as reduced free-riding and coordination problems.[1]

In contrast, the advising function has received far less attention, although its importance is already emphasized by early survey-based studies such as Mace (1971), who suggests that boards fulfill an advisory role, and Demb and Neubauer (1992, p. 43), who find that "setting the strategic direction of the company" was considered by two thirds of the directors as one of their tasks. Based on an evaluation of minutes of board meetings of Israeli firms, in which the government owns a substantial share, Schwartz-Ziv and Weisbach (2013) characterize boards as "active monitors" and find evidence for both advising and monitoring behavior. Fama and Jensen (1983) also argue that outside directors provide support to top management when dealing with specialized decision problems besides their role as managerial monitors, but suggest that internal managers on the board contribute specific knowledge about the organization's activities to the decision making process. Coles et al. (2008) follow the idea that internal managers provide firm-specific information and find that firms for which the knowledge of the

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[1] For early papers on board size see, for example, Yermack (1996) and Eisenberg et al. (1998). Board independence is studied by Weisbach (1988), Byrd and Hickman (1992), Borokhovich et al. (1996), and Brickley et al. (1994), among others. For a comprehensive overview see Hermalin and Weisbach (2003) and Adams et al. (2010).

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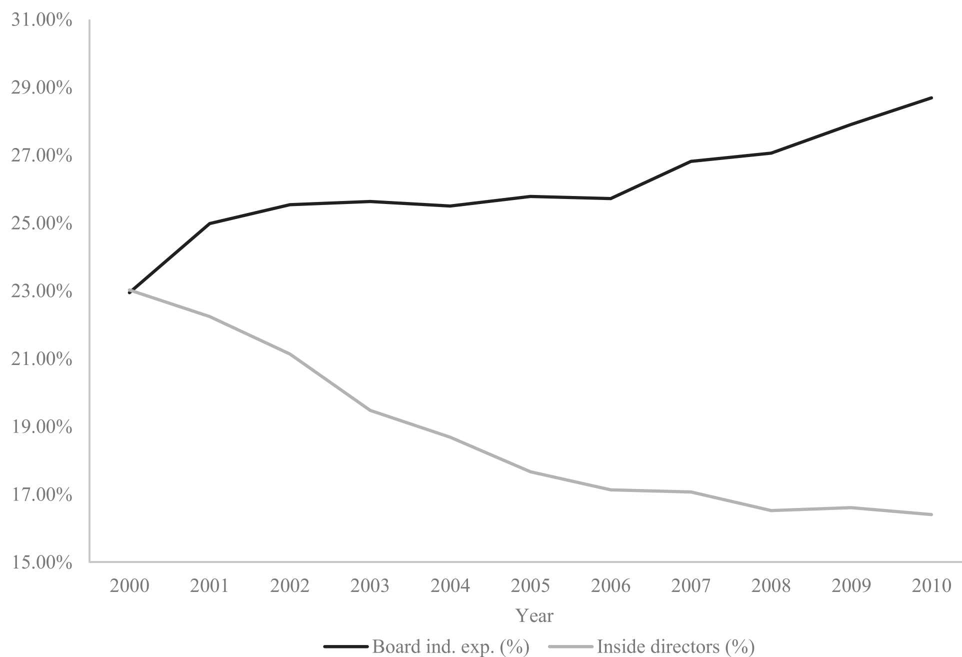

Fig. 1. The evolution of the percentage of inside directors and industry expert directors on the board.
Note: The figure displays the mean percentage of inside directors and the mean percentage of outside directors with industry experience, measured as of the annual meeting during the 2000-2010 sample period for all S&P 1500 firms, excluding utili-ties (standard industry classification (SIC) codes 4900-4949) and financial firms (SIC codes 6000-6999).

inside directors is more important, e.g., research and development (R&D) intensive firms, benefit from a higher fraction of inside directors on the board. Therefore, the two tasks that a board fulfills result in a trade-off: enhanced organizational knowledge provided by inside directors comes at the cost of reduced monitoring resulting from hiring fewer outside directors.[2]

In this paper, we posit that outside directors with specific knowledge of a firm's business combine these desirable characteristics and are thus in a better position to exert both the monitoring and advising functions. Specifically, we propose and empirically test industry experience of outside directors as a measure that captures a board's superior capabilities to provide monitoring and advice. We conjecture that board industry experience positively relates to firm value, reflecting a board's ability to perform its role in a manner that enhances shareholder value.

Anecdotal evidence supports our claim. Recent survey evidence among directors suggests that industry experience is seen as the top attribute sought in new directors (Corporate Board Member, 2014; Deloitte, 2015, LLC). In addition, in the aftermath of the financial crisis of 2008/2009, concerns that industry experience on corporate boards is insufficient have been raised (Pozen, 2010; Bertsch, 2011). Amendments to the Securities and Exchange Commission's disclosure rules introduced in 2009 also reflect an increased interest in director experience, attributes, and skills.[3] At the same time, the fraction of insiders on corporate boards decreased remarkably due to regulatory pressure. For example, the listing rules of the New York Stock Exchange and Nasdaq require (most) listed firms to have a majority of independent outside directors on the board. Removing inside directors from the board arguably limits the availability of firm-specific knowledge to the board of directors and may explain the observed shift in focus from board independence to board industry experience. Fig. 1 confirms that the fraction of inside directors on the board decreased by 29% over our 2000–2010 sample period, while the fraction of industry experts among the outside directors increased by 25%.

In our empirical analysis, we measure board industry experience, defined as the percentage fraction of outside directors with prior work experience in the same two-digit standard industry classification (SIC) code industry, for all industrial firms in the S&P 1500 index from 2000 to 2010. Our results show that firms with more board industry experience are valued at a premium compared to firms with less experienced directors on the board. This valuation effect is statistically significant and economically relevant. In particular, an increase in board industry experience by one standard deviation is associated with an increase of approximately 5–7% in firm value. When we control for a comprehensive set of corporate governance and board structure variables, board industry experience remains statistically significant across all specifications. In addition, when breaking down our board industry experience variable into different types of industry experience, we find the results to be mainly driven by industry experience gained as an outside director, and to a lesser extent as a CEO, thus corroborating our conjecture that experienced boards both advise and monitor a company's senior management.

Our results survive a battery of robustness tests, including alternative industry classifications and measures of board industry experience on at the firm-segment level rather than at the firm-level. We find that our results are neither driven by active affiliations of directors within the same industry nor by general managerial experience. We run a number of additional analyses in an attempt to mitigate endogeneity concerns. Most importantly, we use an event-study setup and analyze director deaths that occur randomly and represent an exogenous shock to the board structure. The death of an experienced director is associated with a three-day cumulative abnormal return that is 1.3–1.6% lower as compared to the death of a director without industry experience. The economic magnitude of this finding becomes even slightly larger when we restrict our sample to a subset of "sudden" deaths, including strokes, heart

[2] This trade-off is modeled in Raheja (2005) and Harris and Raviv (2008), who show that both board size and the fraction of insiders and outsiders on the board are a function of director and firm characteristics. In Harris and Raviv (2008), shareholders can even be better off with a board fully comprised of inside directors.

[3] The amendments can be downloaded at: https://www.sec.gov/news/press/2009/2009-268.htm.

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