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Enhancing Value Through Corporate Governance

The role and importance of corporate governance has evolved over recent years following a number of corporate scandals and the demise of well-known corporations. Matters around the globe such as Enron, Parmalat, Satyam and Olympus all highlighted a lack of corporate governance as one of the primary reasons for their respective downfalls. For private equity investors, the extended holding period of portfolio companies, resulting from tighter credit markets and a lack of available exit routes, has increased the significance of corporate governance not only to protect businesses but also as a means to enhance enterprise value.

The importance of good corporate governance cannot be underestimated but unfortunately is often overlooked, as underlined by the failure of notable corporations. From a private equity investor's perspective, these cases demonstrate the importance for corporate governance assessments to be a part of the pre-acquisition due diligence process. A comprehensive due diligence reveals more than the data provided as it should analyse the investment risk and opportunities, evaluate a company's governance practices, perform background checks on the target company's history of compliance and other governance issues.

These cases have made better run companies appreciate that governance needs to move beyond box-ticking and that regulatory codes are essential but not necessarily adequate, prompting a need for management to be proactive, and implement systems and controls which exceed regulatory requirements. Post-acquisition, this is an area where private equity funds are able to positively influence the portfolio company and create value, and funds are expected to play an increasingly critical role in shaping corporate governance practices in their portfolio companies.

The purpose of corporate governance is to increase the accountability of a company, safeguard stakeholders' interests, avoid business disasters and ultimately enhance value for stakeholders.

Private Equity's Role in Corporate Governance

Private equity investors are well positioned to influence a portfolio company's corporate governance through:

- **Active engagement:** By taking a board seat, private equity firms can influence decision making. Through their board involvement, they can also introduce best practices which promote transparency and efficiency.
- **Providing longer-term focus:** Given that private equity investors make their return on the exit of an investment, they tend to have the company's long term interest in mind, unlike management which may have shorter term interests. Thus, there is a greater focus on growth and value creation.
- **Providing best practices:** Private equity firms will want to ensure that their companies are well-governed to guarantee a clean exit. They will also want to protect their investment and mitigate the risk of reputational damage, which could be caused by a corporate governance scandal in an investee company. As their investment is more often than not illiquid, this removes the option of a quick disposal of assets in a crisis situation. Therefore, it is in the private equity firm's best interest to ensure that their companies are not only compliant, but governed at the highest possible standard.
- **Stop the rot, change the future:** With the introduction of capital, provision of resources and by taking board / management positions, private equity funds have the leverage and standing to take steps to cut out the inefficient and poor / improper practices of the past and put in place measures to shape the future.

What Does Good Governance Look Like?

Corporate governance is a set of systems and processes which ensure that a company is governed in the best interests of all its stakeholders by improving the corporate performance and accountability. Poor governance, internal controls and systems could lead to a failure to detect or anticipate improper behaviour and fraud. So what does good corporate governance entail? The key hallmarks of good corporate governance include:

- **Board composition and makeup:** There needs to be a strong and independent board structure with an appropriate balance of non-executive and independent directors to protect the interests of shareholders, provide a clear division of chairman and chief executive roles as well as distinguish separation of ownership from management. The latter is mitigated when companies are private equity backed. Board sizes also need to be considered, as larger boards can make it more difficult for a CEO to dominate. For private equity funds, active ownership provides a competitive advantage as it equates to more influence and the ability to manage key stakeholders. For minority investors, it is in their interests to have a corporate governance framework that enables them to influence through voting rights, access to information and a board seat.
- **Transparency:** Transparency over business information and particularly financial records help gain shareholder confidence. A company should ensure that adequate disclosures are made. Transparency over business transactions, particularly related party transactions, can provide a level of assurance that business activity is not fraudulent.
- **Ethical business conduct and integrity:** Promoting ethical conduct and moral decision making can retain the confidence of stakeholders and sets the example for expected conduct.
- **Strong committees:** Having particularly strong audit and remuneration committees ensures accountability and compliance with respect to the stakeholders' best interests. The audit committee should safeguard the integrity of a company's financial reporting by implementing a committee structure with a mix of non-executive and independent directors.
- **Executive compensation:** The issue of executive compensation has become a hot topic and has questioned the very basis of governance structures adopted by companies, with many stakeholders wanting to see more performance-related pay. The remuneration committee should ensure that the level and composition of remuneration is reasonable.
- **Accuracy and timeliness of reporting:** Improving financial reporting, coupled with disclosure and transparency, enables early detection of poor performance and hence influences value.

The Role of Corporate Governance in Emerging Markets

Whilst developed countries already possess corporate governance codes, many emerging markets have an immature or underdeveloped corporate governance culture. Poor corporate governance is particularly an issue in many Asian emerging market countries where fraud is not uncommon. The family aspect of businesses in these countries adds to the complexities as there are vast numbers of owner-managed businesses. With substantial amounts of cross-border investment, for emerging markets to remain an attractive investment of foreign capital, it is important for regulators to foster a legal and regulatory framework which instills investor confidence through transparency and assurance in management. Therefore, steps must be taken to improve corporate governance practices and codes of business conduct. Weak regulatory and legal systems can be a deterrent to private equity investors.

The challenge for private equity firms is the extent to which they require the patriarch / management / business partners in emerging market businesses to conform to practices that the firm would usually require in developed market businesses. Fund managers who are not prepared to require proper governance or take action against improper conduct or take the view that "you have to accept some level of fraud in Asia" will be sending a clear message that management of the portfolio company can and will take advantage of. Ultimately, fund managers will risk their investment not maximising its value potential.

As the many corporate governance scandals in the West have shown, corporate governance challenges are not limited to emerging markets. In Japan, companies are finding themselves facing the same challenges. The ruling in the recent case involving Olympus concluded that key information was only available to limited personnel, resulting in undetected window-dressing practices. The corporate governance failings in this case have shed light on the fact that many companies in Japan lack independent board members. At Olympus, only three out of 15 board members were independent non-executives, which was above average for Japanese companies. Subsequently, these events have raised concerns over corporate governance standards in Japan, leading many to believe that increased levels of accountability and transparency through tighter rules and regulations are required if Japanese companies are to attract long-term investors. The tightening of regulations will cause companies to reassess their corporate governance practices as compatibility with global standards will become increasingly critical to the success of a company.

The on-going challenges and risks presented require a robust operating environment with vigorous internal controls and comprehensive compliance policies that are addressed and assessed regularly.

Enhancing Value

Good corporate governance enhances value in a number of ways. Firstly, it sends a positive signal to investors and promotes market confidence – which in turn affects firm value as many investors attach a premium to businesses with a solid corporate governance framework. Companies with high corporate governance standards are considered more attractive investments and are generally more marketable for a trade or secondary sale as these standards affect reputation and credibility.

Secondly, it mitigates risk and can be the difference between the success or the demise of a business, as, if effective, it can prevent fraud and sustain the enterprise value of a business. In addition to mitigating risk, better corporate governance can improve a company's performance, as it tends to mean more efficient management, better asset allocation and greater efficiency improvements. For instance, it can be argued that adopting best practice can help companies achieve sustainable growth and profitability and thereby creating value.

Thirdly, solid corporate governance can impact the availability and cost of capital for all firms. As such, good governance and robust internal controls can be considered key drivers for long-term value enhancement. Strong frameworks can lead to more efficient use of capital and attract investors at a lower cost of capital. Without solid corporate governance, investors may not have the confidence that they will receive sufficient return on their investment in the business. Consequently, banks may not lend to companies and investors may not buy equity. Not only does good corporate governance enable access to capital, it provides a basis of negotiation for businesses up for sale. On the flip side, weak corporate governance reduces investor confidence and can discourage outside investment, as they can be considered too risky. Whilst financial performance, growth potential and market considerations remain the key factors in investment decisions, corporate governance practices are increasingly becoming an important part of investment criteria.

Finally, tighter corporate governance rules and regulations have had a detrimental effect on the number of IPOs. Many fast growing companies are reconsidering their IPO strategies and are choosing to remain unlisted to avoid compliance with stricter regulations. It could be argued that this could hinder or limit the growth potential of some companies. With IPOs being one of the exit routes available to private equity firms, it is important to have strong governance frameworks in place, particularly in emerging markets such as China, where tighter regulations and assessment processes have been implemented for IPO applicants.

Examples of Value Creation

Practical examples of adding value include:

- Use of KPIs and appropriate incentives to ensure that businesses can measure performance against a metric. KPIs can be used to monitor progress and benchmark businesses against industry and competitor standards, thereby flagging any issues and areas for improvement. Moreover, it provides objectivity and goals for employees.
- Standardising reporting so that businesses can be properly analysed to see where costs are higher and losses are being made. This provides a single standard of measurement and facilitates comparison by enabling businesses to compare like for like information, for example between various divisions. Streamlining the reporting process and ensuring that the information is meaningful and relevant to managers enables better decision making and can help create value.
- Development of strict contract approval processes to stop favourable arrangements (i.e. kickbacks for customers / suppliers) and to provide assurance to investors that suppliers have been chosen due to their suitability, rather than their relationship with employees of the company.
- Faster reporting and use of flash reports and dashboards to identify key trends and increase responsiveness. Dashboards can make trends visible to management and due to the use of real time data, this enables a constant data flow as opposed to waiting for monthly or quarterly reports. This process can make the entity more efficient and can trigger a faster response to issues through the visibility of trends. Reports can also be customised to different levels of management.

Conclusion

No matter what size or where corporations are, they face a range of risks and regulatory issues. We have seen companies collapse as a result of poor governance, thereby heightening the need to protect businesses through strong compliance programs. Corporate governance is an area which should be looked at across all stages of the investment life cycle, from pre-acquisition to exit stage, to ensure that the portfolio company is an attractive investment to potential acquirers. Every company is different and therefore, corporate governance needs to be tailored accordingly to minimise risk and maximise value.

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