

IMPROVED CORPORATE GOVERNANCE DRIVING PREMIUM RETURNS

Improved corporate governance is leading to improved returns for some international private equity investors.

Consider the recent \$3.4 billion acquisition of Africa's cellular carrier Celtel by Mobile Telecommunications Company (MTC) of Kuwait. According to MTC Chief Financial Officer Sam Deeb, who was speaking at a conference hosted by the International Finance Corporation (IFC) in May 2005, MTC was attracted to the deal because of Celtel's "transparency, commitment to clean business, first class board directors, and first class shareholders, which gave MTC the confidence to go to Africa," he said.

Speaking at the same IFC conference, Dr. Mohamed Ibrahim, Chairman of Celtel, proudly proclaimed a zero tolerance policy for any influence payments. "We have not paid a single dollar for any license or any favor. You can do business cleanly in Africa. We have engaged the courts whenever we found a problem, and we have won every time. We built a company based on principle, and that made us an appropriate company for the international markets."

The IFC has seen the value of corporate governance in its own private equity portfolio, and has initiated a new program under the direction of Teresa Barger, former head of the group's private equity funds. According to Barger, "the data shows that better governed companies sell at higher multiples of EBITDA. Moreover, the less trusted the macro environment, the more gains are realized from improved corporate governance." Research led by Stijn Claessens for the World Bank has also showed that, "the higher cost of capital, and the corresponding lower firm valuation, translates into economic costs" for companies in countries where there are lower standards of corporate governance.¹ He also states that, "investors seem to apply a discount in their valuation for firms and countries with relatively worse corporate governance."

Brazil provides an interesting case study for corporate governance and its importance to the equity markets. In 2002, the Brazilian Institute of Corporate Governance (IBGC) and the Sao Paulo stock exchange (Bovespa) introduced a new listing segment known as the Novo Mercado. In the past, Brazilian companies were allowed to issue two classes of shares, one with voting rights and one without, shattering any notion of shareholder accountability. In order to qualify for a Novo Mercado listing, a company must now only issue one class of shares with equal voting rights.

Investors have responded positively, revealing a preference for listings under the new Novo Mercado standards. In the last 18 months, there have been 12 IPOs in Brazil, and 10 were

registered under the Novo Mercado. It took two years to gain traction, but, according to Antonio Bonchristiano of GP Investimentos, "2004 was the year of the Novo Mercado. We now have a clear set of standards in place, and the momentum for good corporate governance will continue to positively define private equity in Brazil. Brazil's commitment to setting high standards for corporate governance should give a lot of comfort to both international and domestic investors."

Corporate governance has also been a factor in Asia's surge in private equity activity. Since the IMF's \$58 billion bailout package in the late 1990s, 11 countries have issued regulations requiring independent directors, and eight have required audit committees. These developments have been tempered somewhat by weaker provisions issued in Japan, where the standards are recommended, but only optional, and in Korea, where some of the standards are only applicable to larger companies. According to Jamie Allen of the Asia Corporate Governance Association, corporate governance is currently "only a thin veneer in Asia," but he believes "private equity players such as Ripplewood in Japan's Shinsai Bank and Lombard and Newbridge in their Korea transactions are helping to push the process forward." According to Allen, "some of the truest innovation is coming at the small and mid-cap level, where entrepreneurs see corporate governance as a way of differentiating themselves in order to attract capital."

Improved corporate governance has been one of the critical drivers for the explosion of international investments in India's private equity market. According to Jayanta Banerjee of ICICI, one of India's oldest private equity investors, there has been a "sea-change in the way corporate governance is viewed by company managers. It used to be a buzzword, but in the last two years, managers are making specific efforts to improve corporate governance because they now know that it is critical for attracting capital and achieving growth."

Guidance is available for investors who are making corporate governance part of their investment strategy. The IFC has formulated a set of tools to help broaden the understanding of corporate governance among private equity investors and their portfolio companies. The IFC matrix laying out a typical progression toward better governance is shown in the table on page 10. These tools are available at: www.empea.net/peindustry/standards.aspx. Key elements include commitment to good governance, board governance and independence, control systems, disclosure and transparency, as well as the important factor of how minority shareholders are treated.

Banerjee believes that the IFC standards will assist private

continued on page 10

Corporate Governance, continued from page 9

equity players to build a better understanding about corporate governance, but equally important is the need to "inculcate a culture of corporate governance in each portfolio company." In order to support a better culture of corporate governance, ICICI includes corporate governance as part of its evaluation of investment targets, and "does not invest where we do not see openness on the part of managers to high governance standards," he said.

While there is an increasing focus on issues of corporate governance in portfolio companies, some industry leaders are also highlighting its importance at the fund manager level. At a recent industry conference, Jeremy Collier of Collier Capital, a leading secondaries firm with \$3.5 billion under management, issued a warning. "Although most private equity fund managers espouse and practice high standards of corporate governance, if we as an industry fail to ensure that clear and strong standards are adopted by all general partners - everywhere - we risk allowing the bad apples to define us. This would lead inevitably to heavy-handed government regulation. Private equity creates wealth, builds and revitalizes companies, and even transforms national economies, but heavy-handed regulation could kill the goose that lays the golden egg," Collier said.

Corporate governance is a paramount issue at all levels of the private equity industry. According to Barger of the IFC, "the agreements that define a GP-LP relationship are the starting point for good corporate governance. When I began managing IFC private equity funds in 2000, partnership agreements were often filled with strange, self-interested clauses, and some made no mention of fund governance mechanisms. It was not uncommon to find GPs who did not understand that they were providing a service to LPs, and did not understand their fiduciary duty in managing other people's money. With the professionalization of emerging markets fund management, this mindset has pretty much vanished."

¹ Claessens, Stijin. "Corporate Governance and Development", Published by the International Bank for Reconstruction and Development, World Bank, 2003. P.16.

For more information:

- <http://www.empea.net/peindustry/standards.aspx>
- http://ifcln1.ifc.org/ifcext/corporategovernance.nsf/Content/CG_Tools.
- [http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/M-ListCom.pdf/\\$FILE/M-ListCom.pdf](http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/M-ListCom.pdf/$FILE/M-ListCom.pdf)
- www.acga-asia.org

**CORPORATE GOVERNANCE PROGRESSION MATRIX
FOUNDER/FAMILY – OWNED (UNLISTED) COMPANIES**
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Attributes	Level 1 Understanding the need to professionalize the company	Level 2 First concrete steps toward best practices	Level 3 Implementation of best practices	Level 4 Leadership
Commitment to Corporate Governance	Basic formalities in place: - Board of Directors - Annual Shareholders meeting - Shareholders and shareowners identified and recorded. - Board member or high-level executive governance responsibilities	Written policies established: - Succession planning - Human resources & family-member employment - Share ownership by non-family investors - Management/Board approves corporate calendar	Corporate Governance policy covers: - Roles of board & management - Long-term planning for corporate governance of company commensurate with business plan	Best practices commensurate with listed companies including: - Accounting, auditing & internal controls - Shareholder communications - Total compliance with country's voluntary best practices code
Structure & Functioning of the Board of Directors	Board of Directors constituted and meets periodically.	- Board Meetings held according to a regular schedule. Agenda prepared in advance, minutes prepared and approved. - Non-family members appointed - Review of board to assure mix of core competencies - Independent Advisory Board (if needed)	- Board composition includes mix of competencies adequate to fulfill oversight duties. - Annual evaluation conducted - Audit Committee of non-Executive Directors established - Independent directors appointed to the Board	Oversight of key functions achieved: - Audit committee composed entirely of independent directors - Nominating Committee established
Transparency & Disclosure	Systems in place including: - Internal accounting & control system reviewed by independent auditors - Quarterly financial reports prepared by internal accounting & Board approved - Annual financials audited independently & approved by Shareholders Meeting	Accounting & auditing: - Performed in accordance with highest national standards - Audit performed by recognized international accounting firm	Accounting, auditing and internal control systems up to international standards.	
Shareholders	- All shareholders kept informed of company policy, strategy & results - Annual shareholders meetings	Shareholders provided with all material information and detailed agenda in advance of shareholders meetings	Family council established if number of family members large or substantial portion are not working in the business	Company in position to quickly implement all aspects of best practice code with respect to shareholders were the company to go public