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# Global Corporate Governance Guide 2004

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# Corporate governance and private equity

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Private equity funds differ from other types of investment funds mainly in the larger size of their holdings in individual investee companies, their longer investment horizons, and the relatively fewer number of companies in individual fund portfolios. As a result, it is reasonable to expect private equity managers to have a greater degree of involvement in their investee companies compared to other investment professionals, such as mutual fund or hedge fund managers. And because of their greater involvement, private equity managers are naturally expected to play a larger role in influencing the corporate governance practices of their investee companies.

Certainly, sound governance does not invariably equate to strong performance. There is no guarantee that well-governed companies will produce smooth exits and high returns for private equity managers, although a number of studies have indicated positive correlations between governance and stock performance. However, there is an implicit understanding among most private equity managers that poorly governed companies are more prone to failure. Hence, there is a strong element of self-interest for private equity managers to ensure that their funds are invested only in well-governed companies or in companies that are willing and able to improve their governance, and to avoid investment in poorly-governed companies which demonstrate no inclination to improve their governance.

The public reaction to the recent series of scandals in the US corporate and financial world constitutes a key force behind the drive for better governance. Public awareness of this subject has seldom been higher and large institutional investors, such as CalPERS (the California Public Employees' Retirement System), have become increasingly vocal in demands for governance improvements. Meanwhile, the Sarbanes-Oxley Act enacted by the US Congress in 2002 has made certain governance standards a legal requirement for US corporations.

To varying degrees, the impact of these recent events in the United States and similar events and legislative actions in Europe, has been felt in all major markets around the world. As a result, many private equity managers have been led to re-assess their attitudes towards corporate governance, if not their roles in improving governance practices. There is a stronger risk today than ever before that a private equity firm's reputation will suffer should an investee company in its portfolio become embroiled in a corporate governance scandal. In the worst case, from the manager's perspective,

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investors will avoid investing with such the private equity firm in the future, even if its own governance is fully acceptable. Indeed, many limited partners in private equity funds – the “outside” investors – are now demanding far greater standards of transparency and disclosure from the private equity managers themselves.

This chapter is divided into two parts. The first part discusses briefly the importance and benefits of corporate governance from the perspective of private equity managers, while the latter summarizes several ways in which private equity managers can, and often do, exert influence on their investee companies to promote better corporate governance. This article hopes to demonstrate that promotion of good corporate governance should be an intrinsic function of every private equity investment, not solely to comply with the requirements of good citizenship or the law, but also for the simple reason that good corporate governance rewards and protects the investor.

### Benefits of corporate governance for private equity investors

The proposition that private equity managers should play a meaningful role in improving the corporate governance practices of investee companies rests upon the assumption that the managers, and ultimately the investors in their private equity funds, will benefit from this involvement. While the demands of public opinion, institutional investors and regulatory requirements should bear their fair weight, self-interest remains the most effective force to ensure the promotion of sound governance by private equity managers. On this point, private equity managers do stand to benefit from sound governance in several respects.

The first benefit pertains to better protection. Private equity managers often seek to protect their investments and ensure optimal exit strategies through legal contracts as well as through vigilance and engagement. Legal contracts relating to private equity investments often contain clauses giving the

private equity investor certain rights, such as the right to veto a material decision by the board (where the private equity investor holds only a minority position), or the right to force the company to redeem the securities sold to the private equity investor should the investment turn out to be unprofitable. One could argue that this is a more reactive or less preferred form of protection. The problems at the investee company are likely to have reached a critical level if the private equity manager must resort to such contractual rights for resolution.

On the other hand, private equity managers rely much more frequently on vigilance and engagement. As one can imagine, the effectiveness of this approach draws significantly upon the quality of governance in the investee companies. Since good governance requires adequate transparency and an effective board, there is a greater likelihood for the private equity manager to detect problems, and engage with management to take remedial actions early on, in a well-governed company. Where management itself is the source of problems, having an effective board to deal with management becomes even more important.

Good corporate governance, then, can be seen as a proactive or preferred form of investor protection, as there is a better chance when such governance prevails for problems to be identified and resolved swiftly before they escalate to a crisis level. Private equity holdings typically involve substantial stakes and are often illiquid; private equity managers, therefore, unlike mutual fund or hedge fund managers, seldom have the option of disposing of their holdings quickly when an investee company encounters a major crisis. Thus, corporate governance is a critical means of protection for private equity managers.

However, a second benefit of corporate governance to private equity managers—better company performance—is often less palpable. It may be easier to attribute a successful business to readily identifiable factors such as strong management, innovative products, superior services, and high demand. Although good governance by itself cannot produce a successful business, several key features of corporate governance clearly help to drive company

performance. Disclosure or transparency enables early detection of poor performance, as described previously; accountability requires that poor performance be addressed by management; while the promotion of best practices and the drive to create long-term value for shareholders maintain management's focus on the ultimate goals for the company.

Good governance also helps to enhance a company's reputation and credibility, making it more attractive to all interested parties. It is natural to expect employees, customers, suppliers, creditors, government authorities, and potential investors to prefer dealing with a company that is transparent and well-run. Companies that benefit from high standards of corporate governance, especially in the areas of transparency and disclosure, are also much more marketable. They are easier for outside parties, such as underwriters or investors, to access and understand. Private placements or public offerings – exit paths for private equity investors – are greatly facilitated.

As the ultimate goal of every private equity investment is a profitable exit, a chief concern of private equity managers is whether the benefits of good governance described above will actually be reflected in the company's stock price: that is, whether the market is willing to pay a premium for a well-governed company. A number of recent studies on the relationship of corporate governance and the value of equity in public companies indicate that there is indeed such a premium.

A recent study conducted by Professor Lawrence Brown of Georgia State University in February 2004, covering 5,460 US public companies, found that companies with superior governance practices tended to have better stock price performance, as well as higher profitability, larger dividend payouts and lower risk levels, than their industry peers. A January 2004 study by Lipper Inc, a global provider of mutual fund information, covering 725 mutual funds in the United States, found that funds whose portfolios included a heavier weighting of companies with strong corporate governance outperformed funds with lower weightings of such companies over three and five-year periods.

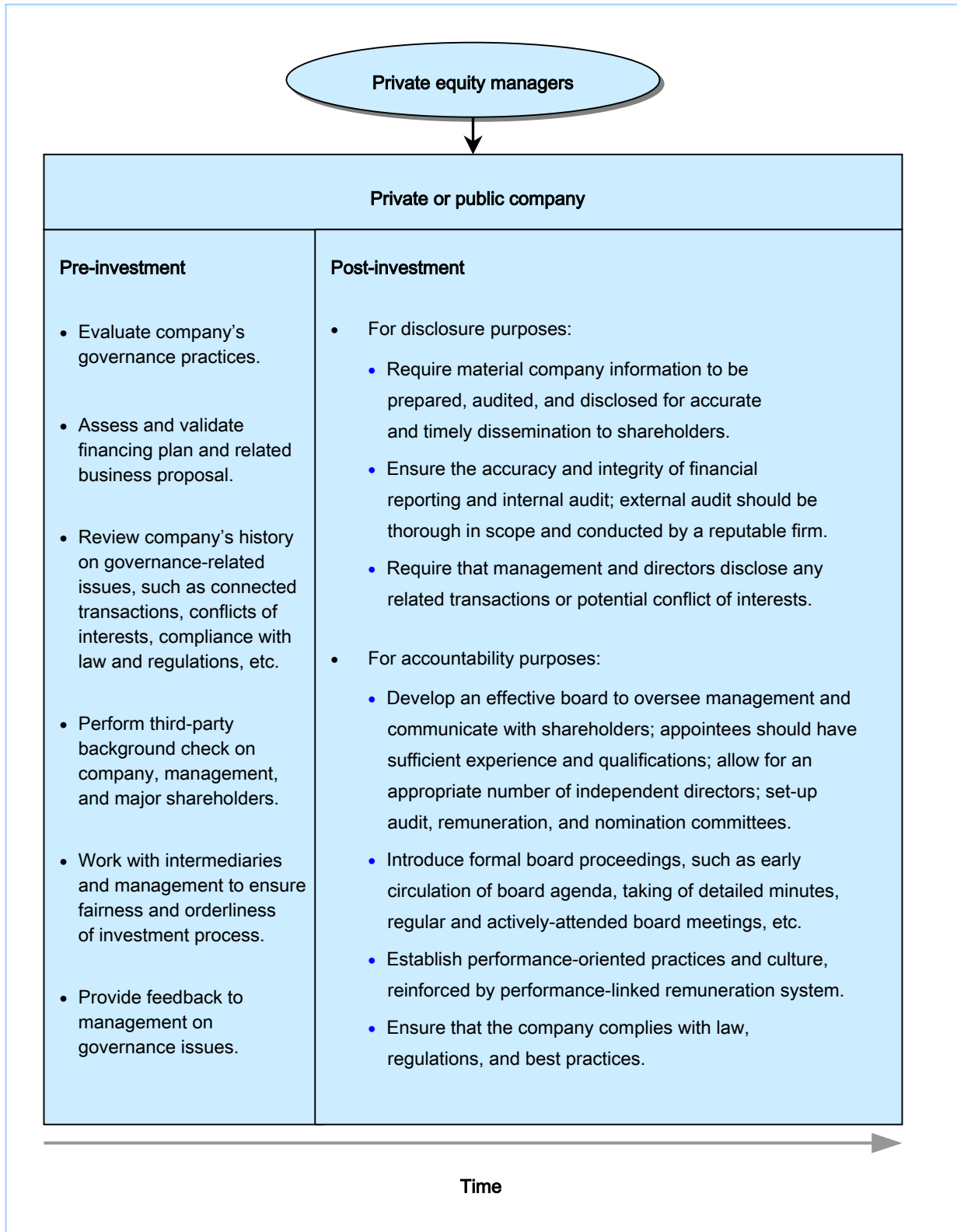
Similarly, in a study published in April 2003, Credit Lyonnais Securities Asia and the Asian Corporate Governance Association uncovered a strong positive relationship between the quality of corporate governance and stock performance over a period of five years in their survey of 380 public companies in 10 different Asian markets.

### [The role of private equity in promoting corporate governance](#)

Private equity managers need to address the corporate governance issues of a business from the day when they first meet with management to consider an investment, right up to the time when a complete exit from the investment has been made. During this entire period of interaction with the company, which may last three to five years or longer, private equity managers may become involved, through their participation on the board and engagement with management, in a wide variety of governance activities, ranging from customary exercises - such as validating management's business plan, counseling management on making the board more effective, or improving financial reporting and disclosure - to unusual undertakings, such as investigating financial irregularities or assisting management in corporate restructuring or acquisitions. Hence, by virtue of their longer investment horizon, frequent participation on the board and continuous engagement with management, private equity managers are uniquely positioned to play a catalytic role in promoting sound governance practices. That role is even stronger in a buyout or majority stake acquisition, where a private equity manager exercises substantial control- not just influence as in minority stake investments - over a company's governance matters.

The opportunity for private equity managers to promote sound governance practice actually begins during the pre-investment stage, as depicted in the diagram on the following page.

Most private equity managers will gauge a company's governance standards through their



meetings with management and the quality of information provided by management during the due diligence process which precedes an investment. Some private equity managers will do so based on their professional experience; more established firms may use an internal set of corporate governance guidelines for evaluating investments. Even though private equity managers are not yet investors at this stage and lack a formal role in the company, they have the ability to influence management on governance-related issues through their questions and feedback. Their opinions should bear significant weight if the management of the target company is looking to raise private equity capital and knows it must address investor concerns.

Private equity managers also promote corporate governance directly through the investment selection process itself. The selection process reinforces good governance by way of rewards and refusals: well-governed companies are likely to be rewarded with the funding which they are seeking, while poorly governed companies are likely to be refused and advised to improve their governance practices. Nevertheless, there are occasions when private equity managers may make conscious decisions to invest in poorly-governed companies. In such a case, a private equity manager typically would require management of the company concerned to agree to legal covenants requiring specific, time-bound governance improvements as part of the legal documentation at the time of acquisition of an interest in the company. Such an investment may, if the governance covenants are successfully carried out, result in a situation in which both parties stand to benefit, the company from improved performance, and the private equity investor from enhanced value.

After an investment has been made, the role of private equity managers in influencing corporate governance becomes more formal and direct because of their status as investors, and frequently as board participants. Private equity managers at this stage can engage both the board and management by proposing and working with them to implement or

improve governance standards. As mentioned earlier, private equity managers, compared to other types of professional investors, should be in the best position to influence the governance standards of the company because of both the duration and depth of their involvement.

However, prudent private equity managers will need to calibrate the extent of their demands and expectations for improvements in corporate governance accordingly in the context of the size of their holding in the company, the listing status of the company, and the business culture and environment in which the company operates: “one size fits all” does not work in corporate governance. For example, private equity managers who own a small, negligible stake and share a board seat with other private equity firms in an investment syndicate may need to adopt a more diplomatic and longer-term approach in pushing for governance implementations or reforms. In the case of private companies where ownership is closely held, private equity managers may also need to be content with a slower pace of corporate governance reform. Meanwhile, private equity managers running a multi-country portfolio should be mindful of the need to tailor governance requirements based on each host country’s business culture and environment. It may be unrealistic to expect an investee company rapidly to adopt world-class governance standards in a developing country where the financial and legal systems are still inchoate. Private equity managers need to be realistic and pragmatic in attempting to champion sound governance in their investees.

Finally, private equity managers need not limit their role in promoting sound governance strictly through their interactions with investee companies. Advocating sound governance can be as simple as adopting a supportive stance and voicing it under appropriate circumstances, be it through media interviews, speaking engagements or social interaction with the business community. Good corporate governance rewards and protects the private equity investor. Promotion of good corporate governance is just good business sense.