"Corporate Governance for Venture Capital and Private Equity Investors in Asia"

Presentation by:

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at

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Agenda

1. Governance for private firms and their investors: Why it matters.

2. Developing a governance policy for your fund:
   - Questions to ask first
   - Screening potential investments
   - The due diligence process
   - Shareholder agreements
   - Governance strategies for investee companies
   - Your own governance

3. Asian impact
   - Private equity as a catalyst for improved corporate governance.

1. The why of governance

- Organisational factors

1. Governance is good for its own sake: all complex organisations need to be governed (ie, directed, guided and controlled) as well as managed. Organisations need checks and balances. People cannot, and should not, supervise themselves. Good governance can breed efficiencies.

2. All business organisations sit in a web of relationships (shareholders, creditors, suppliers, customers, employees, the media, government). It is often hard for managers, being so close to operations, to view these matters dispassionately and manage them all effectively. Sharing responsibility with a board of directors should bring balance and result in better decision-making.

The why of governance

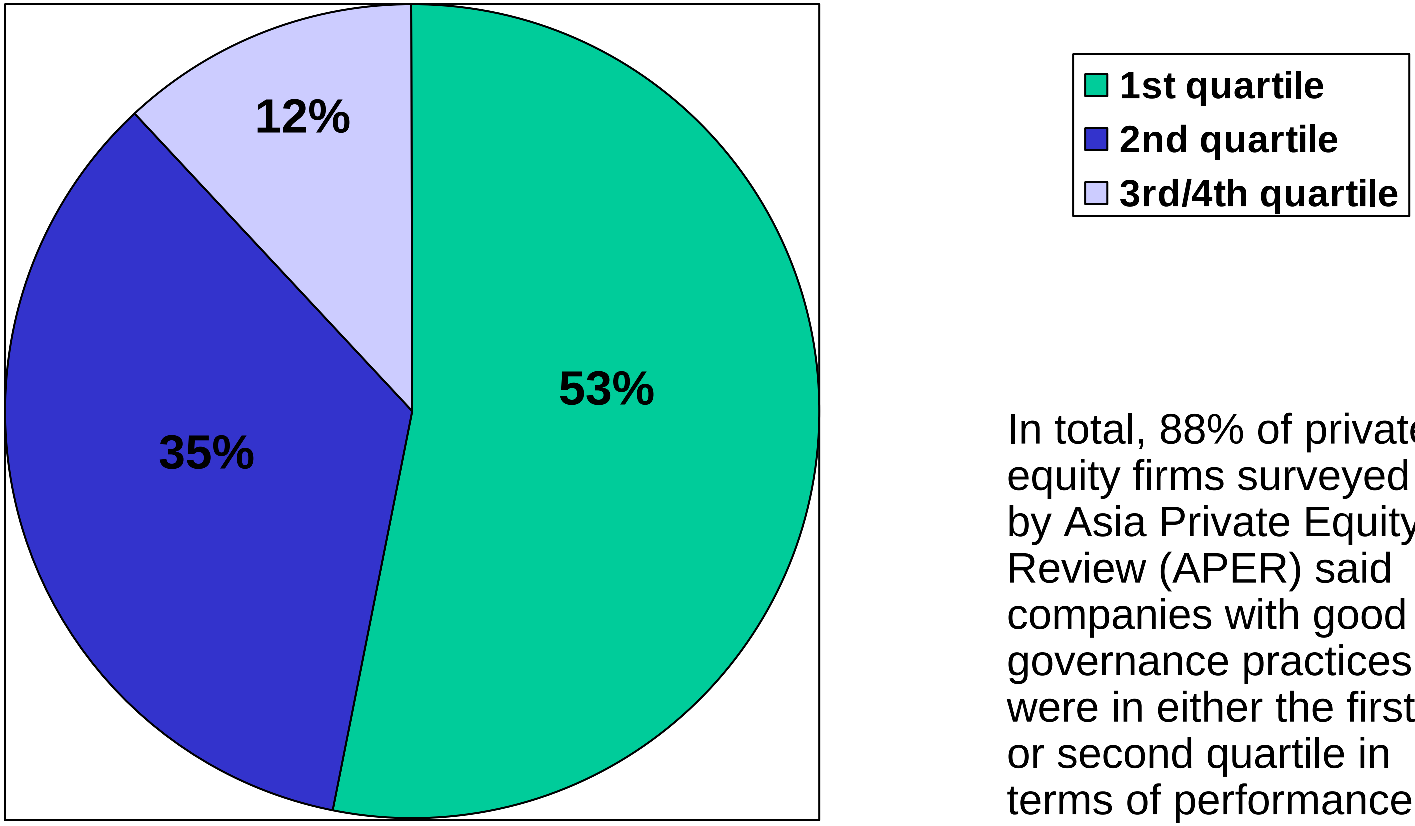
- Investor-related factors:

1. The venture capital and private equity industries can play an important role as a catalyst for good governance in Asia. This is not about altruism, but protecting your investments and creating optimal exit strategies (whether through an IPO or sale to a strategic investor).

2. Institutional fund managers are under increasing pressure to ensure they act, and are seen to act, in the best interests of their investors. Pressures within the public-equity markets are filtering through to private equity.

Good governance = performance

APER Corporate Governance Survey 2003



In total, 88% of private equity firms surveyed by Asia Private Equity Review (APER) said companies with good governance practices were in either the first or second quartile in terms of performance.

The emerging political context

- A number of factors have been conspiring to force greater transparency and accountability from the public and private equity industries worldwide:
  - Stock market declines and scandals: demand for greater accountability from financial institutions as well as corporates, accountants and lawyers. Plus demands for greater standardisation globally of rules on accounting/auditing and corporate governance.
  - The growth of the investment industry and the placing of large amounts of public pension fund money into alternative investment vehicles.
  - Expanding regulatory coverage: today fund managers; tomorrow hedge funds; the day after private equity?
  - The watchdogs are being watched.

Partners under pressure

- In recent years, the media, trade unions and employees in the US have been lobbying public pension funds to disclose the performance of their private equity investments. First CalPERS, then other state institutions such as the University of California.
- Limited partners (LPs) in private equity funds have therefore applied pressure on their general partners (GPs) for more information. The effects are felt worldwide, because some of these funds operate outside the US.
- Although there is speculation that some GPs will cease to take public pension fund money as a result (eg, see Institutional Investor magazine, August 2003, pp 52-56), this is not likely to be feasible for all fund managers.

The industry takes pre-emptive action

- Private Equity Industry Guidelines Group (PEIGG):

  - Released the "US Private Equity Valuation Guidelines" in December 2003. *(See www.peigg.org)*

  - Promotes use of "fair value" in valuing investments.

  - The stated aims are economic and commercial: to improve the "consistency, transparency and comparability of private equity valuations" and the efficiency of reporting; and to promote the "growth and maturation of the private equity industry" through "a common valuation system agreed on by both limited and general partners".

  - There is also a political objective: to promote self-regulation and stave off regulatory interference.

Not just a US movement

- PEIGG sought input from:
  - National Venture Capital Association (NVCA)
  - Institutional Limited Partners Association (ILPA)
  - European Venture Capital Association (EVCA)
  - British Venture Capital Association (BVCA)

- EVCA also has its own guidelines on valuation and reporting. *(See www.evca.com)*

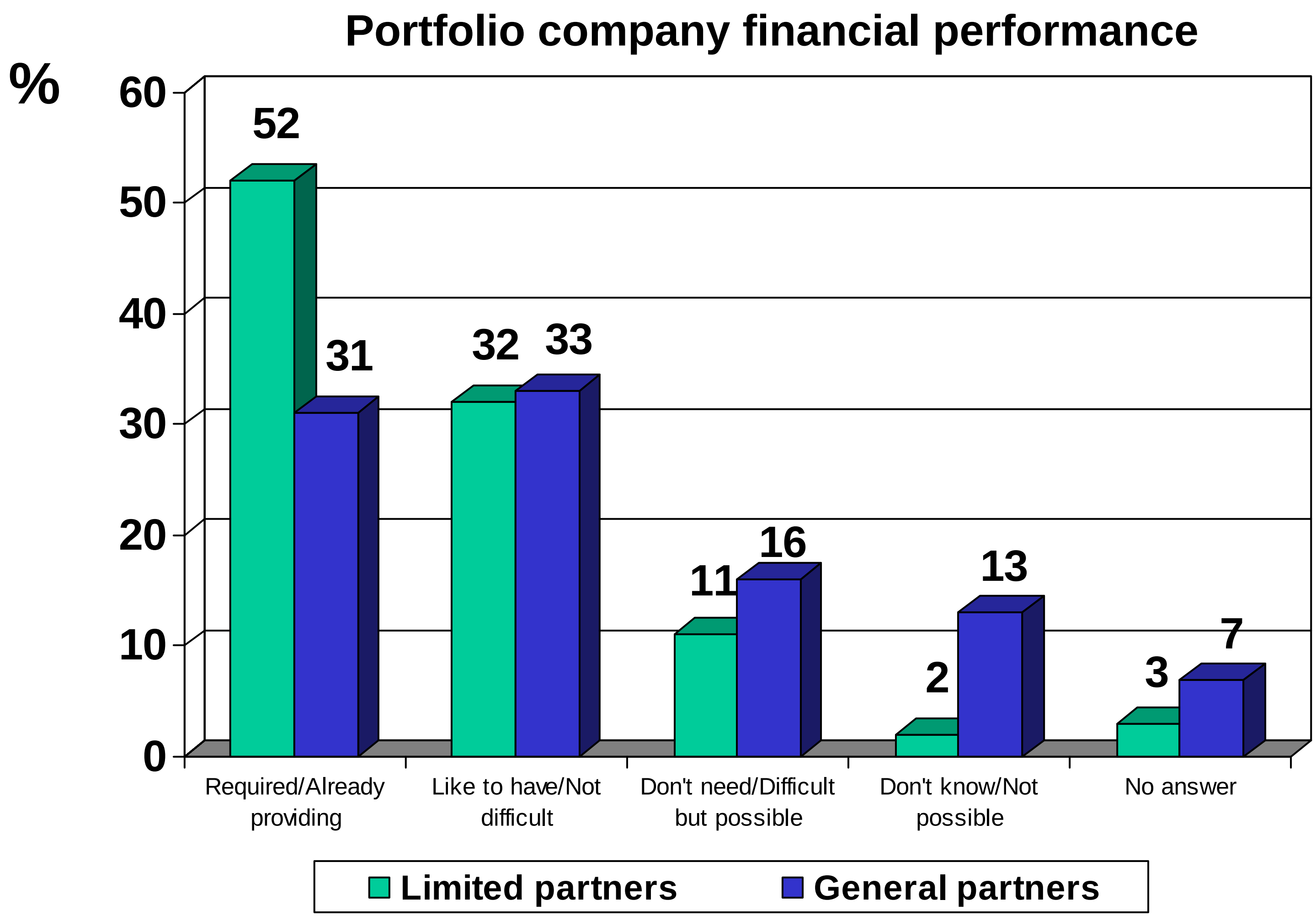
- BVCA produced updated valuation, and new reporting, guidelines in June 2003. *(See www.bvca.co.uk)*

Status report

- <u>PEIGG Reporting and Performance Measurement Survey</u>, February 1, 2004

- Key findings:
  - Demand from limited partners (LPs) for digital reports, as opposed to hard copy ones, greatly exceeded the supply from general partners (GPs).
  - A general information gap between what is required/desired by LPs and what is being disclosed by GPs (especially in the area of portfolio company financial performance and fund performance).
  - Primary reason for the gap appears to be concerns among GPs over confidentiality of information.

Reporting gap



The survey asked a series of questions about whether various financial measures, capital structure and accounting policies were required by LPs and provided by GPs.

Source: PEIGG Survey, p9.

2. Developing a governance policy

- Suggested questions to ask first:
  - How important is governance to our investment strategy? Is it of fundamental or only secondary importance? Will we apply it rigorously in all our investments?
  - How activist do we want to be in engaging our investee companies on governance issues?
  - What resources (people + time + financial) can we devote to these tasks?
  - What staff training is required?
  - Do we need to hire outside consultants from time to time?
  - How often will we review our policy? (Is it working?)
- Do in cooperation with your entire team (if possible). Don't delegate to one person as a side issue.

➢ Screening potential investments

- Do you consider governance factors when screening potential investments? Or do you leave it to the due diligence phase?

- If Yes, how extensive is your initial screen?
  - ➢ Accounting policies (local GAAP; IAS)
  - ➢ External audit evidence (any qualification?)
  - ➢ Quality of financial reporting
  - ➢ Board composition, experience of directors and committee structure (if any)
  - ➢ Internal controls and risk management (if any)
  - ➢ Do you actively look for red flags?

- Logic: better to catch potential problems sooner rather than later.

The due-diligence process

- What detailed financial and non-financial criteria do you use?
  - Do you borrow governance standards from the public equity sphere? (eg, Cadbury Report, now part of the UK Combined Code, which itself was recently revised; the new codes of best practice in Asia; NYSE or NASDAQ standards; public pension fund principles, such as CalPERS or TIAA-Cref)
  - Do you adapt them for assessing private companies?
  - Do you have higher standards for publicly listed companies?
- How often do you update your checklist?
  - Probably need to do it once a year at least.

Governance in one country

Official governance reports & codes in the UK		
NAME	**FOCUS**	**DATE**
Cadbury	Corporate governance	1992
Greenbury **“Combined Code”**	Remuneration	1995
Hampel	Corporate governance	1998
Turnbull	Internal control	1999
Myners	Institutional investors	2001
Higgs	Effectiveness of non-executive directors	2003
Smith	Audit committees	2003
Tyson	Recruitment of non-executive directors	2003
UK Combined Code (Revised)	Corporate Governance	2003

Public vs private

- Some public-equity standards may not be applicable, or not immediately applicable, to private firms:
  - Independent non-executive directors comprising around 33% of the board: what if your minority stake allows you only one board seat? Would you give this to an independent? How do you achieve the 33% in any case?
  - Audit and compensation committees have immediate relevance, but nomination committees may depend on the size of the board, size of your stake, and the nature of the ownership structure.
  - If there are few or no independent directors, then requiring board committees to be chaired and composed mostly of such directors is an impossibility!

Dangers

- The proverbial box-ticking problem:
  - In trying to improve governance standards we run the risk of encouraging and facilitating the very thing we deplore—form rather than substance.
  - But form is an important element. It sets up the structure and processes for substance. Shouldn't denigrate it too much!

- Not sufficiently assessing character and reputation of the company and individual managers—because such "soft things" are difficult to quantify.
  - "What one can't measure, one ignores."

➢ Shareholder agreements

Generally agreed to be a key element in managing the governance of investee companies. APER 2003 survey found that:

Expectations of private equity fund managers	
Veto power over major decisions	95%
Right to appoint senior management	81%
Right to appoint non-executive directors	81%
Issue a housekeeping list	76%
Right to appoint/change auditors	71%

Question

- On their own, are traditional shareholder agreements enough? Do we put too much faith in them?

- Shareholder agreements are only one part of the corporate governance chain. There also needs to be an ongoing dialogue with investee companies on governance issues, changing standards and so on.

➢ Governance strategies for investee companies

- Tailor a governance strategy for each investee. Given your likely exit strategy, what changes do you need to make over the 3-5 year holding period?

- Start as early as possible and give yourself time to make mistakes. Starting later is more difficult, costly and inefficient.

- Build from the basics (eg, board meetings, agendas and minutes), if they are lacking.

- Formalise and make transparent things that were informal and opaque (eg, selection of directors; executive compensation).

- Consider what other elements of the company (eg, internal audit) needs to be closely involved.

Developing strategies for investees

- Differentiate between types of companies:
  - Publicly listed vs private firms.
  - Size: small, medium or large.
  - Stage of company and board development.
  - Investee company’s own strategy.
- This will help to determine:
  - Level of standards and practice you can expect.
  - Implementation timeframe.
  - Resources that investee company can devote to reform.
  - Capabilities of investee company to manage reform.
  - The amount of monitoring you will need to do.

Dangers

- If your exit strategy is an IPO, especially one in the US, beware of “dressing to impress” (ie, putting in place big governance changes just a few months before the listing). Increasingly, investors are seeing through this ruse.

- Start “early grooming” at least two to three years before the IPO. This will give you more credibility and allow the company time to sort out teething problems and get used to its new systems. Two years is a short period in governance time.

Your own governance

- In light of growing pressures for greater transparency and accountability among fund managers:
  - How is your board structured?
  - What checks and balances exist within your organisation?
  - How often do you report to your investors?
  - What investment do you need to make in terms of staff training or retraining? New financial IT systems?
  - Would you meet the standards you require of your investees?

3. Asian impact

- Has the venture capital/private equity industry been a catalyst for better governance in Asia?

  - Overall, the answer is Yes. Although the industry has not moved as quickly as expected to develop common guidelines or codes. Also, fewer funds than expected have publicly nailed their colours to the governance mast.

- Some notable deals:
  - Thai Union Frozen, Bangkok (Lombard)
  - Shinsei Bank, Tokyo (Ripplewood)
  - Korea Exchange Bank, Seoul (Lone Star)

Conclusion

- Improved governance brings organisational and performance benefits to firms; plus generally better returns and fewer surprises to investors.
- Fund managers are under increasing pressure worldwide to improve their own transparency and accountability.
- Develop a governance policy for your fund and a governance strategy for each investee. Look upon this as a chain of events from initial screen to due diligence to entry and exit.
- Venture capital and private equity have been a catalyst for better governance in Asia. Please do more!!

ACGA Website

Go to

www.acga-asia.org

to keep track of corporate governance developments in Asia, ACGA activities, and governance events.

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