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Corporate Governance

Time to consider its role in building shareholder value



Harold Lloyd displays weakness in assessing and managing risks and is unlikely to be suitable for a Board position.

At Opus Executive Partners we deal with Board level appointments across a wide range of natural resources companies from FTSE100 through the AIM and overseas exchanges to private companies. Corporate governance is widely used as a term and increasingly so. But the new Corporate Governance Code¹ is not high on everyone's reading list and the further one goes from FTSE100 companies the less people understand about what it is and how it can potentially help their business. We decided to write this article in order to express our opinion based on our direct dealings with companies, shareholders, banks and institutions etc., in order to position corporate governance as a road map for shareholder value. Even though the value and importance of the Code is recognised in the larger companies, we believe that smaller companies can potentially gain significant benefits from incorporating its spirit and principles to a greater extent than we currently observe. The Quoted Companies Alliance have very recently published their updated "Corporate Governance Guidelines for Smaller Quoted Companies" which addresses corporate governance issues for quoted companies that do not have a premium listing.²

"Good governance helps to underpin long-term performance and so matters to all companies, irrespective of their size" – Baroness Hogg, Chairman of the Financial Reporting Council.

¹ The UK Corporate Governance Code, Financial Reporting Council, June 2010, www.frc.org.uk

² Corporate Governance Guidelines for Smaller Quoted Companies, The Quoted Companies Alliance, September 2010, www.theqca.com

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Not many in the City would consider Harold Lloyd, the comedian pictured above, as an ideal model for good corporate governance. But why? Isn't risk taking and being a bit different a hallmark of many of the great industrialists and entrepreneurs for generations? Well, taking risks with your own money is one thing, but when shareholders invest in a listed company they need to know that risks are being properly assessed and managed – as formally recognised by the new Corporate Governance Code.

Natural resources companies tend in our experience to be started by a small number of individuals who believe they can create value through identifying and developing mineral and hydrocarbon resources. In the early stages it is possible to assemble a portfolio of opportunities using a small team that is generally focused on geology. But the road to success requires a broad range of management skills and an overarching need for capital: drilling wildcats and appraising ore bodies is an expensive game and contains high levels of varied risks. These characteristics differentiate natural resources companies from other businesses. What is required to retain the confidence of shareholders and bankers in activities that are inherently risky? And following initial exploration success, what is required to achieve the funding needed to support the development of mines and oil and gas fields?

We suggest that part of the answer is good corporate governance. But what is it? Is it an ongoing process that is integral to the workings of a Board, or is it some sort of audit process which is done occasionally to satisfy some requirement but which is not central to day-to-day business activities? Corporate Governance is described as being what the Board of a company does and how it sets the values of the company. Its purpose is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company. So we see that Corporate Governance underpins the company. Some might even call it a management theory or blueprint.

Let us be more specific. There are five main principles of the Code. These are Leadership, Effectiveness, Accountability, Remuneration and Relations with Shareholders. There is also The UK Stewardship Code³ that expands the arrangements for engagement between institutional shareholders and companies. We intend to address each of the above in some detail in future articles in this series. But for now we wish to consider what the Code offers to shareholders.

This brings us to an immediate problem. Whilst institutional shareholders are certainly aware of the importance of Corporate Governance – and indeed may have a Corporate Compliance Officer – most other shareholders know little or nothing about the subject. Where there is mixture of active institutional shareholders and retail investors, the interests of the latter are to some extent covered by the former. However, if institutions perceive a company as having poor corporate governance, they are unlikely to invest in it. This leads to a potential vicious circle: poor corporate governance dissuades the institutions, which are then unable to help the company improve its corporate governance because the institutions are absent. Furthermore, the market capitalisation of a company is important to the larger institutions, whose rules may preclude them from investing in companies that they consider too small.

³ The UK Stewardship Code, Financial Reporting Council, July 2010, www.frc.org.uk

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How can this vicious circle be broken? If the company takes visible and effective steps to improve its corporate governance, the institutions will be more inclined to come on board and will then be able participate in the required dialogue with the Board. Investment by the smaller institutions in a company with good corporate governance can then, in the success case, make that company attractive to the larger institutions and hence further assist the company's expansion.

In any case, few companies can operate without the need for external funding in the form of debt or equity, and without good corporate governance the terms and conditions under which such funding would be available would probably be disadvantageous. In the current global economic climate where the supply of capital is limited, we believe that any company that takes building strong corporate governance seriously will have a competitive advantage over those who do not. It can also be the case that companies with weak Corporate Governance will be unable to attract the best candidates for their Board positions.

“Companies from around the globe choose to list in London in large part because of the reputation of the London market, and the UK corporate governance regime is central to that standing” – Tracey Pierce, Director of Equity Primary Markets at the London Stock Exchange Group.

Good Corporate Governance, we suggest, should begin at the earliest stage i.e. prior to IPO, and then be progressively advanced and developed as the company moves forward. For example, a company that is seeking a listing and has a well-structured Board is likely to command the confidence of potential investors and this could lead to a higher valuation at IPO. For example, a discount of 20% on a £100 million equity raising would be £20 million lost. An example at a later stage would be a company requiring some additional working capital to accelerate progress of a project. If potential investors are confident in a company and its governance, funds may be raised at a current share price or even above. Yet with doubts on the governance, poorer quality investors may be the only source of funding leading to shares being issued at a heavy discount to the current price. This leads to unnecessary dilution and can also drive the share price down – another example of a vicious circle. Furthermore, debt funding is likely to involve significantly higher interest rates if the banks are uncomfortable with the company's corporate governance. Another example would be transition from AIM to Main Board listing, where corporate governance is a key issue. And a company whose share price is depressed because of shareholder concerns over corporate governance is less likely to command full value for those shareholders within merger and acquisition corporate transactions.

We believe that if shareholders were more aware of the purpose, character and potential benefits from good Corporate Governance their investment decisions would be better informed. Companies would similarly benefit from a stronger shareholder base.

We hope that the above thoughts and observation based on our extensive experience in Board appointments demonstrates that Corporate Governance is an integral and ongoing part of building company value. We do not believe that a “one size fits all” approach is appropriate because the needs, size and circumstances of companies do

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vary considerably. However, the days are long gone since the legendary Tiny Rowland famously said that non-executive directors were little more than decorations on a Christmas tree. It is clear to us that companies that recognise the importance of good corporate governance to help them deliver long-term shareholder value and success have a competitive advantage over those that do not.

In the next article we will discuss in detail what constitutes good Corporate Governance specifically addressing the first of its five principles – Leadership. It covers the role of the Board, the Division of Responsibilities, and the roles of the Chairman and the Non-Executive Directors.

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Oxana is an experience executive search consultant and at Opus she deals with board-level and senior management-level executive appointments on a worldwide basis. She has extensive knowledge of the natural resources companies operating on the London, Toronto, Australian and other international stock exchanges. Oxana also leads Opus' activities in the field of corporate governance, strategic studies related to board composition, board performance and succession planning.

Robert Waterhouse - Advisory Board Member at Opus Executive Partners and Oil & Gas Analyst

Robert has been analysing and investing in the natural resources sector for many years and he reviews oil and gas companies for the leading multi-media news organisation Proactive Investors. He is increasingly involved with issues concerning the structure, composition and capability of company boards, an area seldom addressed by resources analysts yet which is central to achieving shareholder value. Robert is also active in the advancement of new technologies for hydrocarbon discovery.

About Opus

Executive and Non-Executive Search

Opus Executive Partners have established an international reputation for excellence in Executive and Non Executive Search serving the worldwide Energy and Natural Resources sectors, excelling at identifying, assessing and attracting leadership talent. Achieving results quickly, skillfully and effectively have made us the partner of choice.

Opus works in partnership with Finding Petroleum, Minesite.com, Oilbarrel.com and Oilvoice.

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