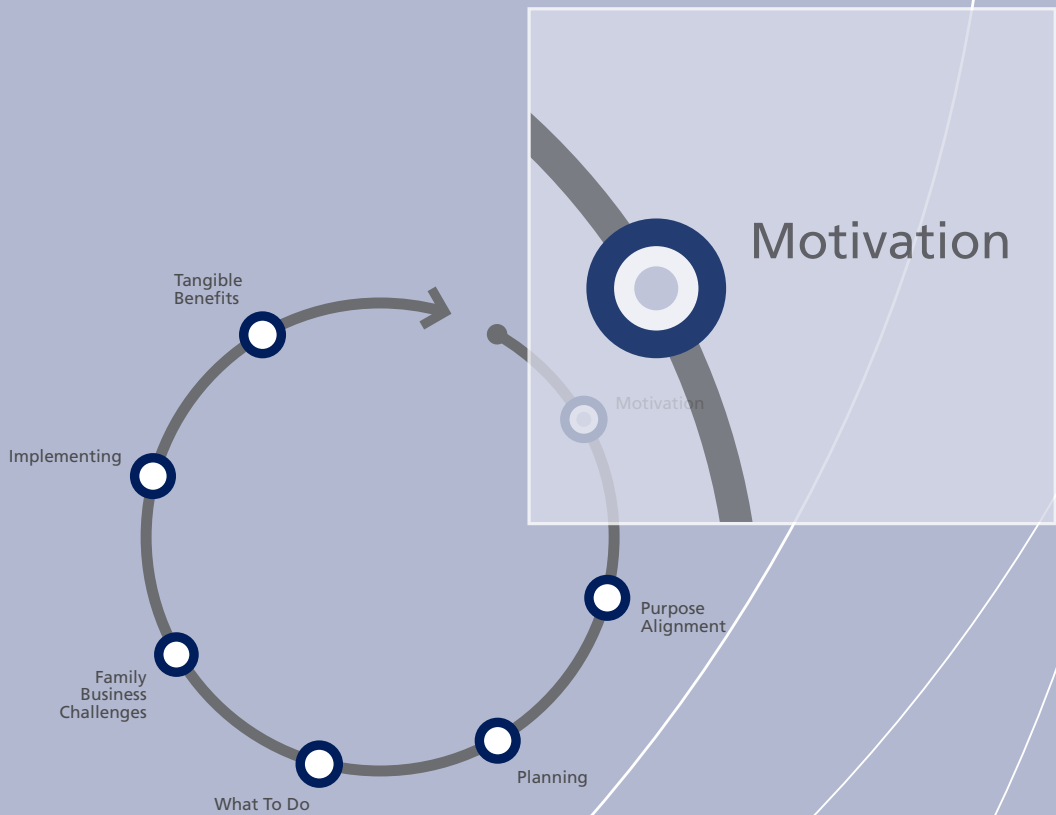


# 1

## MOTIVATION: THE WHYS DEFINE THE WAYS





# Chapter 1

## Motivation: The Whys Define the Ways



### KEY MESSAGES

**Define the motivation.** When starting to think about improving the corporate governance of your company, define the underlying reason or reasons—the motivation— behind those improvements.

**Identify the business benefits.** Your motivation for governance improvements should result from identifying desired business benefits.

**Tailor specifics to desired business benefits.** Your motivation for governance improvements should shape the specific governance measures the company will undertake, as well as their pace and priority.

**A**s in many other aspects of business life, corporate governance practices should not follow the one-size-fits-all principle. Quite the contrary: real experience indicates that the ways to implement and achieve better governance can differ considerably from country to country and company to company, even in the same industry.

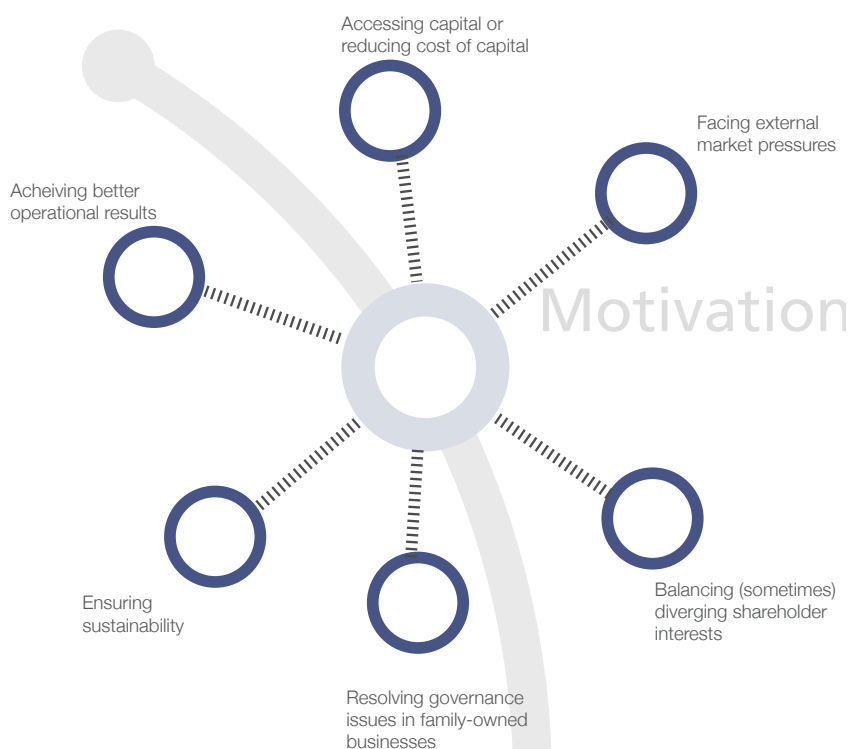
The reasons that drive a company to pursue corporate governance improvements are as numerous and varied as the ways to implement these improvements. In many cases, the decision to undertake specific corporate governance measures comes only after a relatively long period of building understanding about the costs and benefits of such an effort. During this period, key players in the company gain a greater appreciation of what better corporate governance can bring to the business and to its various internal and external stakeholders. In some few cases, the survival of the company hangs in the balance. Here, key players must make governance-related decisions immediately and implementation must be expedited.

The company's motivating factors typically determine prioritization of governance improvement actions and the pace of implementation. Urgent capital needs or the sudden absence of the founder without a succession plan may elevate the importance of adopting practices that resolve such problems. Other companies may move more gradually towards an understanding of the value of good corporate governance, resulting in a slower pace. Either way, specific needs will dictate the implementation process.

The experiences of the 14 Companies Circle<sup>1</sup> members reveal a variety of motivation and actions. Here, the various motivating factors are grouped into categories, which are explored in this chapter.

<sup>1</sup> The Companies Circle was made up of 14 member companies that have demonstrated their leadership in adopting good corporate governance practices, from five Latin American countries. They are: Atlas of Costa Rica, Argos and ISA, from Colombia, Homex, from Mexico, Buenaventura and Ferreyros, from Peru, CCR, CPFL, Embraer, Marcopolo, Natura,

- › Accessing capital or reducing the cost of capital
- › Facing and responding to external market pressures
- › Balancing (sometimes) diverging shareholder interests
- › Resolving governance issues in family-owned businesses
- › Ensuring company sustainability
- › Achieving better operational results



Note that in most cases, a number of motivating factors will play a role in driving governance improvements.

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NET, Suzano and Ultrapar, from Brazil. Since its acquisition by the Mexican company Mabe in 2008, Atlas is no longer a member of the Companies Circle. The practices referred in this guide are from before the acquisition. Now, the Companies Circle is made up of 13 members.

## 1 Accessing Capital or Reducing the Cost of Capital

*“Buenaventura was perceived as a family company with operations concentrated in a developing country. We needed to show the market that we were as open and reliable as any other company in the world. Applying best practices of corporate governance gave us the credibility the market requires of a “new company in the market.” Internally, this meant being more transparent, having better information and being able to improve decision-making. Within Peru we gained additional respect from the business community and other stakeholders. Overall, I estimate that the governance improvements we implemented have resulted in an additional 20 percent increase in our market valuation, a significant contribution to improving shareholder value.”*



—Roque Benavides, Buenaventura, CEO

Company leaders frequently cite the need to access capital as the main reason to initiate corporate governance improvements. In fact, all of the Companies Circle members have cited accessing outside capital and/or reducing cost of capital as one of the important motivating factors behind improving their governance policies and practices.

In many instances, the initial capital contributed by company founders and the capitalization of profits is enough to start up the business and to fund some expansion. Ultimately, though, company success may depend on the ability to access external funding.

The more a company grows, the greater the need for additional capital. There is also an ever higher risk associated with the unilateral financing of the business by a single person or a small group of shareholders. How can the company's leaders tap into the pockets of others? Good corporate governance practices can provide an answer and influence the ways in which companies are able to access additional funding.

Much attention to corporate governance issues in emerging markets has focused on the role good governance can play in improving access to global financing sources. Investors need to feel secure in the knowledge that their rights are being properly protected by controlling owners and management. And they need to know that the company has set up minimum governance mechanisms to reduce the risk of the company's controlling group abusing their powers.

The experiences of some of the Companies Circle members, all publicly-listed firms, highlight the ways in which the need to find additional sources of funding can shape a corporate governance agenda.

### The search for “other people’s money”

The six founding partners of **Cemento Argos**, Colombia’s largest cement company, understood early on the need for more partners. In 1934, when they started the company, they knew they would need other people’s money to finance operations and expansion plans. In the ensuing decades, the group launched eight additional companies in different regions of the country and started operations abroad, backed by a steady stream of funding from external investors.

This path and the pace of constant growth required business practices that would generate confidence among the new partners and facilitate access to investments. Corporate governance improvements were a natural answer to Argos’ challenges, even in the absence of accepted governance benchmarks in the country at that time. Argos entered the public bond market in November 2005, with an issuance of US\$ 197.5 million that was oversubscribed threefold.

### Thinking global, listing local—and international

The quest for growth is part of the DNA of **Buenaventura**, the leading mining company in Peru and one of the largest gold and silver producers in the world. Operating in a capital-intensive industry, Buenaventura decided, from its inception in 1953, that growth through explorations and acquisitions would be its path.

From the beginning, the firm considered joint ventures and offerings through Peruvian and United States capital markets as potential sources for funding its growth plans. The company took some first steps to improve its governance early on. But the decision to make an initial public offering of American Depositary Receipts on the New York Stock Exchange in 1996 triggered a comprehensive shift towards good governance. The initiative drove the company to meet the requirements of American laws and Securities and Exchange Commission’s regulations. Extensive commitments of management time and company resources were needed so that Buenaventura could meet these requirements. In addition to receiving the funding benefits of the new listings, other tangible results included enhanced company decision-making on critical aspects of its business, particularly relative to future directions.

## 1.1 Good Governance Leads to Higher Market Valuations

A growing body of empirical evidence shows that well-governed companies receive higher market valuations. Such firms are perceived as investor-friendly, and this gives investors confidence that their investment will generate returns without violating shareholder rights.<sup>2</sup> These higher valuations are seen not only when companies are acquired by larger firms or when they are newly listed on a stock exchange, but also when their stock price reflects higher multiples.

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<sup>2</sup> See BLACK, B., JANG, H., & KIM, W. (2006). Does corporate governance predict firms’ market values? Evidence from Korea. *Journal of Law, Economics, and Organization*, 22, n. 2, pp. 366-413.; SILVEIRA, A. DI M. DA , & BARROS, L. A. (2007). Corporate governance quality and firm value in Brazil. Available at <http://ssrn.com/abstract=923310>; LEAL, R. P., & CARVALHAL-DA-SILVA, A. L. (2005). Corporate governance and value, in Brazil (and in Chile). *Inter-American Development Bank, Latin American Research Network*. Research Network Working Paper #R-514. Available at [http://www.iadb.org/res/pub\\_desc.cfm?pub\\_id=R-514](http://www.iadb.org/res/pub_desc.cfm?pub_id=R-514) ; BLACK, B. (2001). The corporate governance behavior and market value of Russian firms. *Emerging Markets Review*, 2, pp. 89-108.



## Studies Show Business Benefits: Well-governed Companies Attract Premium Valuations

Well-governed firms in Korea traded **160 percent higher** than poorly governed firms, a study by Korean and US researchers found.

In Brazil, poorly-governed companies could **increase their market capitalization by 85–100 percent** with an overhaul of their governance activities and a shift to good governance, according to two recent studies using broad corporate governance indices.

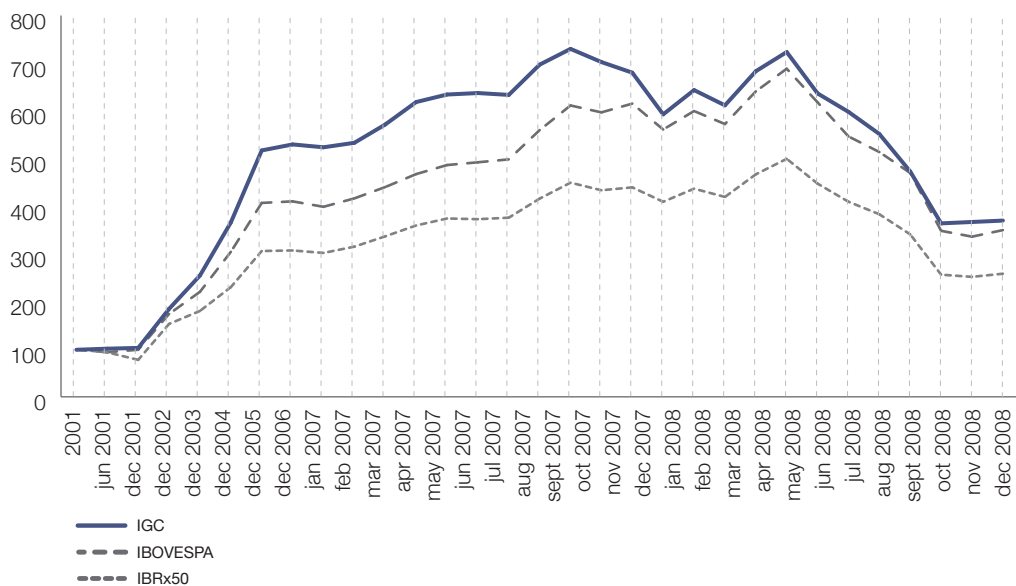
Brazil-based firms with the best corporate governance ratings earned **2004 P/E ratios that were 20 percent higher** than firms with the worst governance ratings, notes a recent ABN AMRO study.

In Russia, companies improving from worst to best in corporate governance could see a **70,000 percent increase in firm value**, according to one small study. While a larger study sample might not show similarly vast increases, the link between good governance and growth in firm value is clear.

A look at the special listing segments of the Brazilian stock exchange, BM&FBOVESPA, demonstrates the connection. The performance of shares of companies on the Novo Mercado, Level 1 and Level 2, launched in 2001 and requiring commitment to higher standards of governance, shows that the stock prices of better-governed companies perform better as well.<sup>3</sup> While better governance practices of the companies listed on the special segments might not be the sole reason for the outperformance of their stocks, it is broadly recognized that these firms needed to make significant improvements to their governance policies and practices to attract the investors in the first place. Figure 1 shows the comparison.

<sup>3</sup> In 2001, BM&FBOVESPA launched its special corporate governance listing segments designed for shares issued by companies that voluntarily commit themselves to higher standards of corporate governance in addition to those already required by Brazilian law and the Brazilian Securities and Exchange Commission. The premium listing segments include Level 1, which requires additional disclosure practices. Level 2 requires everything in L1 plus an assortment of corporate governance practices to strengthen the rights of minority shareholders, such as determining a minimum acceptable price for preferred (non-voting) shares during changes of corporate control, and providing voting rights on certain major decisions of the company. Novo Mercado (New Market–NM) is similar to L2 with the additional requirement that the capital stock must be comprised solely of common (voting) shares. By the end of July 2008, BM&FBOVESPA had 443 listed firms, of which 103 were listed at the NM, 18 at L2, 44 at L1, representing 61.6 percent of its total market capitalization. Details of all special listing segments can be found on BM&FBOVESPA's website [http://www.bovespa.com.br/Home/redirect.asp?end=/BovespaEv/Publications/publ\\_grai.asp?Origem=investor&idioma=i](http://www.bovespa.com.br/Home/redirect.asp?end=/BovespaEv/Publications/publ_grai.asp?Origem=investor&idioma=i).

Figure 1: IGC x IBOVESPA x IBR 50: Comparative Stock Price Performance<sup>4</sup>



Source: Economatica

### Governance improvements precede listing

The experience of **CPFL Energia** is particularly telling. The largest private company in Brazil's electricity sector, CPFL Energia was formed during a tumultuous period in August 2002, a few months after the start of nation-wide electric power rationing. Market participants were confused about the energy supply activity in the country. This environment, coupled with a high exchange rate for the US dollar against the Brazilian real in an election year, created a wave of uncertainty about the country's future. As 2003 began, higher interest rates affected CPFL Energia's operating cash flow. The company needed to raise US\$ 570.5 million, in part to settle debt of more than US\$ 298.4 million coming due that April.<sup>5</sup>

Meanwhile, CPFL Energia had an aggressive investment plan for its distribution operation and for the construction of six hydroelectric plants—four of which are in operation at this writing. To raise the necessary funds, the company restructured its corporate governance, establishing a system to provide a reliable, low-risk relationship between the company and investors, to attract new capital and improve the company's capital structure. Among the positive outcomes of the governance initiatives contributing to higher market valuations:<sup>6</sup>

<sup>4</sup> IGC - Special Corporate Governance Stock Index—is designed to measure the return of a theoretical portfolio composed of shares of companies with a good level of corporate governance. Such companies should be traded on BM&FBOVESPA's Novo Mercado or should be classified at BM&FBOVESPA's Level 1 or Level 2.

IBOVESPA is the main indicator of the Brazilian stock market's average performance, relevant because of two factors: it reflects the variation of BM&FBOVESPA's most traded stocks, and it has tradition, having maintained the integrity of its historical series without any methodological change since its inception in 1968.

IBR-50 is an index which measures the total return on a theoretical portfolio composed by 50 stocks selected among BM&FBOVESPA's most actively traded securities in terms of liquidity, weighted according to the outstanding shares' market value.

<sup>5</sup> USD values provided for Latin American company transactions throughout this guide reflect the exchange rate with local currencies in place during the respective time period.

<sup>6</sup> CPFL Energia's share price rose 64.7 percent from R\$ 16.43 (US\$ 6.22) on December 31, 2004 to R\$ 30.15 (US\$ 12.90) on December 31, 2008.



- Improved financial indicators
- Longer time period to amortize debts
- Lower cost loans

*“The energy sector plays an important role in providing infrastructure for the growth of the Brazilian economy now and in the future. For the expansion of this sort of business we need large investments and long-term investors, like the ones we already have, i.e., pension funds and major corporations, and attracting potential partners in the capital market. We need to offer more than competitive rates of return. We need to ensure high levels of corporate governance in order to build a reliable and solid relationship based on clear information to the market about the way we run the company and our long-term strategies. Since the IPO in 2004, CPFL Energia has been capturing a series of business opportunities, and offered to investors of our subsidiaries the possibility to migrate to the holding company, thus participating in our successful history. All along this path, our Corporate Governance Guidelines have been an important tool, helping us to reintroduce the concept of trust in the electricity sector.”*



—Wilson Ferreira Junior, CPFL Energia, CEO

## 1.2 Attracting and Retaining Shareholders

Improving governance is a critical element of accessing new sources of finance. With all other factors equal, surveys show that when investors have a choice of how to allocate their funds, they tend to prefer better governed companies.<sup>7</sup> But this does not mean that governance improvements should be one-off measures. Companies need to pay constant attention to maintaining high standards of governance. As governance improvements help firms attract new investors and mine new sources of finance, it motivates many companies to keep improving

<sup>7</sup> Global institutional investors managing more than 1 trillion in assets will pay a premium for well governed companies. See, MCKINSEY GLOBAL INVESTOR OPINION SURVEY ON CORPORATE GOVERNANCE (2002), <http://www.mckinsey.com/client/service/organization/leadership/service/corporategovernance/pdf/globalinvestoropinionsurvey2002.pdf>.

their governance practices to retain their existing shareholders or to attract new retail and/or portfolio investors.

### Insufficient internal capacity drives search for outside funding

The founders of **CCR**—Companhia de Concessões Rodoviárias—a consortium of toll-road operators, knew that their own investment capacity would be insufficient to respond to the opportunity offered by the privatization of the huge Brazilian highways network. Although CCR was formed by strong players in the construction business, they understood that they would also need to attract other investors to their capital-intensive toll-road operation.

They knew the task would not be easy. After all, who would consider investing in a company controlled by its main suppliers? The potential for conflicts of interest was obvious and only a credible guarantee of transparency and fairness would satisfy new investors. Balanced governance was the initial response to the challenge. CCR invited Brisa, an international toll-road operator that was not active in Brazil's highway construction industry, to become part of the controlling shareholder group and act as a transparency champion. The restructuring of ownership was the first step towards good governance—equal ownership stakes of controlling shareholders ensured a balance of power. Next, the company implemented a series of procedures and practices that signaled to the market that its governance structure would protect minority shareholders' rights. The result: CCR attracted the additional investors it sought, while retaining the confidence of its existing shareholders.

### Expanding the shareholder base

**Grupo ISA** is Colombia's largest energy transmission company and a mixed-ownership public utilities company. The company was originally established in 1967 as a wholly state-owned enterprise to connect the various regional transmission grids existing at the time in Colombia. But after fulfilling the country's energy requirements, the company drew up plans to expand beyond the country's borders. For this new vision, the capital structure was reconsidered, supported by improved governance practices that led to the following:

- In 2000, ISA became the first mixed-ownership public utilities company in Colombia to democratize its ownership, welcoming new retail shareholders who held 13.62 percent of the company's equity.
- Realizing that the state-as-shareholder might make it more difficult to attract more investors, ISA introduced additional good governance practices to address the doubts.
- This led to a successful IPO, quickly followed by a second tranche in 2002.
- ISA's new private shareholders soon controlled 30 percent of the company.

### Capital-intensive industry requires capital

**NET Serviços**, the largest cable television operator in Brazil, operates in a business that demands significant capital to build its infrastructure. From the beginning, the intent was to include strategic shareholders. These shareholders would take the company public as a way to tap into equity markets, giving it an efficient and diversified capital structure. In the mid-1990s, NET made improvements to its governance practices that enabled it to go public in both the Brazilian and U.S. capital markets.

- In the late 1990s, with corporate governance issues gaining more publicity, NET's shareholders decided that the company should align its governance with what investors were demanding.

- In 2001, the company adopted a first round of good governance practices, joining Level 1 of BM&FBOVESPA's Corporate Governance listing segment.
- Faced with a turbulent macroeconomic environment, even as it aimed to become the leader in the cable television sector, the company realized that it needed fresh, outside capital to meet its obligations and sustain growth.
- To attract this new funding, NET committed to higher corporate governance standards, becoming the second company to advance to BM&FBOVESPA's Level 2.

### 1.3 Decreasing Cost of Capital, Diversifying Capital Structure

The impact of improving corporate governance can go beyond attracting global equity and debt. Domestic sources of equity and debt can also be expected to flow to companies that demonstrate a strong commitment to good governance. Companies may wish not only to obtain new and cheaper sources of equity to fund their operations, but also to diversify their capital structure.

It is a commonly accepted understanding in the corporate world that as investors' risks increase, so will the cost of capital. In recent years, investors providing debt capital have tended to include a company's corporate governance practices, such as a transparent ownership structure and appropriate financial reporting, as key criteria in their investment decision-making process. So, having a good corporate governance system in place ultimately should result in lower interest rates and longer maturity on loans and credits.<sup>8</sup> Bottom line: companies practicing better corporate governance are more likely to obtain reduced costs when incurring debt and financing for operations, thus decreasing the cost of capital.



#### Better Governance Can Have a Positive Impact on Cost of Capital

**Credit rating:** In Romania in late 2004, FitchRatings upgraded the individual credit rating of Banca Comerciala Romana from D to C/D. Standard & Poors raised the bank's long-term counterparty rating from B+ to BB-. Both agencies cited improvements in corporate governance and risk management as the major reasons for the upgrades.

**Valuation:** In Brazil, Credit Suisse raised its valuation of Brasil Telecom in May 2006 from "hold" to "outperform" directly because of improvements in the corporate governance practices by the firm.

**Libor rates and spread reduction:** PREVI, Brazil's major pension fund, compared a portfolio of five investee companies that adopted good governance practices against a group of eight companies with poor governance, by credit rating and costs. The good governance group received a significantly better rating, with improvements achieved after adopting governance best practices. This comparison was considered particularly meaningful due to the strong credit restrictions on the companies' industry sector.

<sup>8</sup> It can be argued that banks and other providers of debt capital may not necessarily require that companies adhere to high governance standards to the extent that certain equity investors would (particularly active institutional investors). This is explained by the fact that banks commonly have better information about the companies they lend to, due to arms-length and one-on-one relationships. Plus banks also have other, additional mechanisms for protecting their rights, such as requiring security for loans. Nevertheless, many banks are active proponents of better governance practices, including of their own clients.

- The governance group accessed the external debt market from 2004–2006. Financing that once cost Libor + 3.875 percent was renegotiated at Libor + 1 percent after governance improvements.
- When issuing debentures, the governance group companies also profited from a spread reduction of 3.5 percent over CDI in 2004 to 1 percent after governance reforms, in 2005.

This section notes that attracting outside capital and reducing its cost is a prime motivator of corporate governance improvements. While this motivation originates largely inside the company and its leadership, other motivations for governance improvements may come from external sources.

## 2 Facing and Responding to External Market Pressures

External pressures can come from global competition, scarce raw materials or changing costs of other company inputs. A central source of pressure also comes from the investor community. Investors have a true interest in reducing their risk by improving governance in investee companies. Studies have shown that corporate governance environments with poor standards and weak enforcement continue to face barriers to investment, with foreign investors facing greater difficulties in obtaining good quality information in such countries. While investors may invest less overall in such countries, for various reasons, like portfolio diversification, they still may consider investment despite weak governance standards, securities regulation and enforcement. In such cases, investors are more likely to select the companies that can be differentiated through their commitment to better governance.<sup>9</sup>

In some cases, external market demands trigger or accelerate the pace of governance improvements at a company.

### Regulatory compliance

New legislative or regulatory requirements can provide an important opportunity for companies to rethink and reshape their governance processes to add more value. **CPFL Energia** took this approach, using requirements for companies listed on the New York Stock Exchange and local listing requirements to find an efficient way to comply with market rules.

The company created a compliance unit to ensure adherence to the market regulations of the exchanges on which it is listed—BM&FBOVESPA and NYSE. The unit also makes sure that the company complies with the various provisions of the Sarbanes-Oxley Act. Company leaders recall that compliance with Section 404 of the Sarbanes-Oxley Act, which deals with internal controls in the preparation of financial statements, required a significant alteration of the company's processes.

### Expanding the capital base

When **NET**'s shareholders started discussing the best way to increase the company's capital as a key element in its restructuring process, issues immediately arose. If not handled properly, the situation could have led to a different treatment of holders of voting and non-voting shares.

<sup>9</sup> LEUZ, C., LINS, K. V., & WARNOCK, F. E. (2008). Do foreigners invest less in poorly governed firms? *ECGI Finance working paper n. 43/2004*.

Aware of the potential problems, the company took the case to the Brazilian Association of Minority Investors, ANIMEC. After extensive and candid discussion at ANIMEC, NET's management shared the Association's recommendations with the company's board of directors.

It is interesting to note that the company anticipated the possible external pressure and handled the situation in a way that would address the concerns. The lively and frank give and take, which brought all parties—including minority shareholders—to the table resulted in a general acknowledgement that sound corporate governance measures could align the interests of all stakeholders. The board identified ways to simplify the capital restructuring process, and resolve the problematic issues.

### 3 Balancing (Sometimes) Diverging Shareholder Interests

In certain cases companies may wind up in situations in which their shareholders have differing interests in the overall direction of the company. Since such situations could hurt the company, these potential conflicts can trigger the introduction of specific governance structures, policies and processes aimed at reassuring all shareholders that their interests ultimately will be protected.

#### Enabling shareholder agreement

Consider **CPFL Energia**'s situation. The company's complex ownership structure involves eight controlling shareholders, three of which are huge industrial groups, and the other five are comprised of pension funds. Clearly, balancing the relationships posed major challenges.

The controlling shareholders interacted through three vehicles:

- The Bradesco<sup>10</sup> Votorantim<sup>11</sup> and Camargo Corrêa groups through VBC Energia
- The Banco do Brasil Employees' Pension Fund—Previ—through a company known as 521 Participações
- The four pension funds of state-owned companies—Fundação Cesp, Petros, Sistel and Sabesp—through a company called Bonaire Participações

Given the diverse nature of the controlling shareholders, it was essential to structure the decision-making process in a way that would prevent the kinds of potential conflicts between shareholders that could hinder the company's development. To accomplish this, the shareholders signed an agreement in March 2002 that defined the conduct, rules and decision-making processes applying to all shareholders in the controlling group. In December 2007, the shareholders' agreement was amended to account for new corporate governance improvements implemented by the company and to adapt corporate mechanisms to the current context.

#### Shareholders' push for liquidity elevates the need for governance improvements

From November 5, 1997, with CPFL Paulista's privatization, to the end of 2004, the controlling shareholders—including pension funds with 55 percent holdings in equity—made huge investments in the make-up of **CPFL Energia** by acquiring CPFL Paulista, CPFL Piratininga, Rio Grande Energia. They made additional investments in energy generation as well.

<sup>10</sup> In December 2006, Bradesco left the control group. It remains a shareholder but its shares now are part of the free float.

<sup>11</sup> In February 2008, Votorantim left the control group.

Given the nature of these shareholders, liquidity was of utmost importance, considered an added value by the capital market and a long-term value-generating prospect. To ensure such liquidity, the company took steps to improve its corporate governance by aligning its practices with the standards of BM&FBOVESPA's Novo Mercado. The company also worked to comply with the requirements of the New York Stock Exchange, by issuing Level III ADSs.<sup>12</sup> These governance improvements included measures explicitly aimed at aligning the interests of different shareholders:

- The migration of minority shareholders of the subsidiaries CPFL Paulista, CPFL Piratininga, CPFL Geração, and RGE to CPFL Energia following a share swap arrangement worth R\$ 560 million and involving approximately 57.000 shareholders
- The alignment of the subsidiaries' corporate by-laws with CPFL Energia's corporate by-laws: CPFL Paulista, CPFL Piratininga, CPFL Geração, Rio Grande Energia, and CPFL Santa Cruz

Other issues to consider when trying to balance sometimes divergent shareholder interests:

- **Implementing practices to avoid favoritism:** The motivation to align founding shareholder interests was also one of the reasons that CCR adopted certain governance measures, such as designing an ownership structure in which controlling shareholders were historical competitors in the construction business. By bringing in an additional controlling shareholder who was not in the construction sector but only in the business of operating toll roads, and by taking other measures such as ensuring a certain percentage of free float of shares and creating an explicit mechanism to evaluate contracts between related parties, CCR was able to demonstrate that it had a structure in place that would ensure a balance of all shareholder interests, rather than favoring the interests of its controlling shareholders engaged in construction.
- **Balancing controlling and minority interests:** There is also a need to balance shareholder interests when dealing with relations between the controlling and minority shareholders. The minority shareholders may be concerned that the controllers will abuse their controlling position—to the detriment of the minority group. This may create problems also for controlling shareholders, as they might be interested in attracting new investors.
- **Appealing to a broader universe of investors:** Many companies may be motivated to improve their governance to make their securities more appealing to a broader universe of investors. These governance improvements will be geared towards providing adequate confidence to existing or potential minority shareholders that their rights will be properly observed and protected. The more actively that the company's shares are traded on the stock market, facilitated by maintaining a high level of free float, the easier it is for non-controlling investors to get in and out of the company. It ensures that shareholders can exit if they disagree on the strategy of the controlling owners and the board, or if they are dissatisfied by the performance of the management. Availability of exit in a liquid market also increases the potential for investors to receive the full value for their stake in the company. To gain agreement on increasing liquidity controlling shareholders, whose control and stake in the company will be diluted, must understand that by giving up some of their shares, they may be able to attract other investors—a move that will likely increase the value of their company and their shares.

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<sup>12</sup> American Depositary Shares (ADS) are the individual shares of a foreign corporation represented by an American Depositary Receipt (ADR).

## Suzano Group seeks share price appreciation.

The main short-term objective of the capital markets strategy adopted by **Suzano Group**<sup>13</sup> was the fast appreciation of the share price. Its board and management needed to demonstrate positive results in the short- to mid-term to ensure a quick win—that the value and benefits of the pro-capital markets movement would be quickly recognized by controlling shareholders.

Why was this needed?

Because implementation of best corporate governance practices as a prerequisite for the capital markets strategy implied the immediate concession of certain control and economic rights to minority shareholders by the controlling shareholders. The controlling shareholders also needed to understand that this would also come with the potential appreciation of share price. The rapid appreciation of the share price would be possible by reducing the risk associated with the company's low stock market liquidity, which could be achieved through equity offerings in the marketplace.

How did the company accomplish this?

The company undertook governance improvements dictated by BM&FBOVESPA's special listing segments, Levels 1 and 2. The appropriate appreciation of company share price together with higher liquidity offers a simple, fair and attractive exit for minority shareholders, including the members of the controlling family and the family's future generations who would want to pursue other business or personal interests, without jeopardizing the company's activities.

## 4 Resolving Governance Issues in Family-Owned Businesses

*"For Suzano, ...(corporate governance) is the warranty of continuity of what founders have seeded. It is the evolution of a dream. We may have accidents along the way, which is natural. But good governance practices favor the continuity of Suzano's companies and make their foundations resistant to the incontestable movement that is globalization."*<sup>14</sup>



—David Feffer, Suzano, Chairman of the Board

<sup>13</sup> The group used to be composed of Suzano Papel e Celulose and Suzano Petroquímica, the latter was sold to Petrobrás in 2007. Today the company is Latin America's largest vertically-integrated producer of paper and eucalyptus pulp.

<sup>14</sup> IBGC, BRAZILIAN INSTITUTE OF CORPORATE GOVERNANCE (2005). Uma década de governança corporativa—história do IBGC, marcos e lições da experiência. São Paulo: Saraiva..

Family or founder-owned companies face unique governance issues. In Chapter 5 these issues and challenges are addressed in detail. But it is important to touch on the issues here as well, because they create motivation for improving corporate governance practices in ways that differ from other publicly-held companies.

Many things in a family business can go wrong. Over time, as the business and the family grow, the family that had been considered the principal source of success could become the source of potential disaster. Among the potential pitfalls that can cause a family-owned company to lose all of its value if they are not handled properly:

- › Ownership and management succession
- › Family employment policies
- › Relations between the family salary-earners and family dividend-receivers
- › Intra-family decision-making processes
- › Providing incentives for hiring and retaining qualified professional non-family managers

Dealing with such challenges to allow the company to survive and grow is yet another motivation for companies to seek governance improvements.

*“Ultrapar had the option to transform itself into a true corporation in the process of succession of its family leadership. It chose to become a leading Brazilian corporation in the capital markets. Professionalization of its management was the way chosen and, in order to materialize the objective, corporate governance started to change. Several milestones occurred: 1997—professionalization of the board, 1999—IPO, 2000—tag-along rights for all shareholders and 2002—the incorporation of Oxiteno and Gipóia. The process of professionalization with the implementation of sound corporate governance practices had culminated with my succession as the CEO by professionals of the group. In 2007, the acquisition of Ipiranga occurred using Ultrapar’s shares as currency, which was a successful process based on corporate governance best practices.”*

—**Paulo Cunha**, Ultrapar, former CEO  
and current Chairman





## Buenaventura transforms

Apart from accessing capital required to expand the company's operations, **Buenaventura's** plans for improving its governance policies and practices were motivated by the desire to transform the company from a family firm to a professionally-managed company. This would align the family's objectives with long-term shareholder objectives, and, eventually, maximize value for all shareholders. Proper governance structures also would help the company to avoid the risks of disagreements among family members capable of harming the company

## Generational shift at Ferreyros.

It is not unusual to witness fights for power among members of second and third generations. Fortunately, this was not the case at **Ferreyros**—a Peruvian company focused on the import, sale and rental of construction machinery and equipment and product support—as heirs had other interests for their careers and lives.

The pattern of ownership and control at Ferreyros has evolved since its founding in 1922, with the number of shareholders and the structure of their holdings changing over time, due to these family factors. The first generation of founding partners passed on their ownership to a second generation, but this generation included some family members who were not interested in the business.

So, more than 30 years ago, Ferreyros' owners turned over the reins of management to professional managers and decided to create a diverse base of shareholders. This turnover required governance changes to ensure that the interests of the family would still be protected and that non-family managers would exercise their best efforts to act in the interests of the company. The governance changes were also motivated by the company's strategic goal to list its shares on the Lima Stock Exchange.

After registering its stock on the Lima exchange in 1971, the company determined that capital markets would become a key funding source. Today, Ferreyros is a well-known player in Peruvian capital markets.

## Suzano and succession planning

The deaths of Leon Feffer, **Suzano's** founder, and Feffer's son Max within a two-year interval motivated an acceleration of the company's corporate governance improvements. While David Feffer, the founder's grandson, was prepared for his new leadership role, it was also clear that family dynamics would likely become more complicated in the future. The governance improvements to address this issue also moved the company toward greater reliance on non-family managers. The company continued to improve on its governance model, with a focus on respecting the company's culture and internal dynamics, while profiting from short-term results. An important milestone: a 2004 strategic planning initiative with action plans that led to continuous governance improvements going forward.

## Unique challenges for a family business.

An understanding of the unique challenges family-owned companies face drove Pery Igel, son of **Ultrapar's** founder, to make an unprecedented move in the local market. In 1984, he arranged for a restricted stock issue to the company's managers as part of a twenty-year employment contract. This would align their interests with the interests of the controlling family and other shareholders. It also would ensure that they would help build a solid company for themselves as well—as long-term co-owners, they would have a financial stake in the company's well-being.

This was the first step in a series of corporate governance initiatives that Igel took, at a time when the term “corporate governance” was not even used. The reason for such bold steps? The desire to ensure the future of the business regardless of family uncertainties and potentially divergent interests.

## 5 Ensuring Company Sustainability

Most companies are formed with no sense of limits on how long the company will operate. It is likely that the founders of many—if not most—founder-owned firms hope that their companies will outlive them. This desire to secure the long-term survival of the company is a motivation for governance improvements. Company owners can help ensure the long-term success and sustainability of the company—by implementing sound corporate governance practices.

### Perpetuating the business and approach to doing business

Finding a way to finance the business was not a concern for **Natura**, the leading company in Brazil’s cosmetics, personal hygiene and perfumery products. The company’s operation was a strong cash generator. In addition, the controlling shareholders’ approach to business generated market trust and created a strong environment for the company’s business activities.

*“What are the reasons for that (going public)?...It is a vision of the future, of thinking about how to perpetuate the company. We had a dream, we began in a backyard. It is a company that grew based on values and has a social role that transcends the interests of the founders. It turned out to be a tool for social and economic development and going public is linked to that, to a process of perpetuating this culture, these values. We want new partners as allies in preserving this culture of commitment to economic development, but also to responsible social and environmental development.”<sup>15</sup>*

—**Guilherme Peirão Leal**, Natura,  
Co-chairman of the Board



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<sup>15</sup> BOVESPA (2004), Como e porque tornar—se uma companhia aberta (Unofficial translation: How and why to become a public company).

The motivation driving the company to take its first steps towards better governance was a little different: the desire to ensure continuity of a particular way of doing business rooted in certain values and beliefs. There was no rush: over the years, the three shareholders, called “commanders-in-chief”, implemented governance practices that were common to publicly-traded companies even though Natura was not publicly-held. Before finally going public, the company received an award for the Best Annual Report, in 2003. The path to better governance was steady and consistent.

Natura wanted to perpetuate not just the business itself. Sustaining Natura’s approach to doing business was also key, because the company believes that corporate social and environmental responsibility is as important for its performance as its financial results.

With its triple bottom line orientation, Natura was motivated toward governance improvements because of its intent to institutionalize and perpetuate the business model and the company’s culture. The three controlling shareholders also wanted to diversify their personal portfolios.

The decision was made: Natura’s shareholders listed the company’s shares on the stock exchange.

For Natura’s owners, this was the way to attract new partners who would help them monitor business conduct—part of a process toward separating ownership and management. As a publicly-traded company, Natura would also be better positioned for future expansion projects, raising funds at lower cost in the market, rather than at commercial lending rates. There were management benefits as well: company owners also understood that a publicly-traded company would have an easier time attracting and retaining top executive talent.

### Sustainability through privatization

Brazil’s **Embraer**, one of the largest aircraft manufacturers in the world, was founded in 1969 as a state-owned company, but was privatized in 1994. In the aftermath of the privatization, the company not only regained its financial soundness, but was able to embark on a new expansion process. The development of new products by Embraer, as well as its future growth, depended on its flexibility to access capital markets. This was the case in 2000, when the company accessed international capital markets through an IPO of American Depositary Receipts (ADRs) on the New York Stock Exchange to finance the development of a new family of commercial jets.

At the time, prior to 2006, Brazilian corporate law limited capital structures in the distribution between common and preferred shares. The nature of Embraer’s structure further limited the company’s access to capital markets. It also restrained the liquidity of company shares, since it constrained the adoption of higher levels of corporate governance standards.

The company realized it needed to take action. On March 31, 2006, the majority of Embraer’s shareholders, including owners of common and preferred shares and ADRs approved a capital restructuring proposal. The plan simplified the company’s capital structure, turning all types of holdings into one—common shares. This move enhanced corporate governance practices and transparency.

The primary goal of the corporate restructuring was to create a basis for sustainability, growth and continuity of Embraer’s operations. Effectively, the restructuring divided up controlling blocks of shareholders. As a result, Embraer became the largest public company in Brazil with fully-dispersed ownership.

Bottom line: without a permanently-defined control block, Embraer's shareholders must meet, discuss and reach consensus on how to align their interests as they make decisions at each general shareholders meeting, and this has contributed to greater transparency.

### **Institutionalizing the company**

Ensuring the company's sustainability was **Homex's** main motivation for adopting good governance practices. Envisioning its future, its management proposed designing several strategies focused on long-term, constant growth of the company, which the board agreed to pursue. Homex's leadership calls this keystone strategy "the institutionalization of the company." Among the steps taken were the creation of a solid governance infrastructure and decision-making procedures emphasizing that the development of the company depends on its governance system and not on specific individuals and establishing conditions to perpetuate the company through time and for future generations.

## **5.1 Attracting and Retaining Managers to Ensure Strategy Implementation**

*"People who are vested with managing responsibilities in all sorts of companies have the obligation of ensuring that these companies will continue into the future and, furthermore, comprehend their real social duties. They must understand that a company is much more than just the property of one or more individuals; it is a part of society itself, providing job opportunities and a setting in where a great number of people may pursue their professional development."*

**Roque Benavides**, Buenaventura, CEO



Financial resources flow to organizations with a solid and outstanding team gathered around a common vision and mission, able to implement the strategic plan. A management team comprised of non-family professionals or one that combines competent family managers with outsiders is often the governance agent that makes things happen in a family-owned company. It is important that the selection of senior managers be done in an objective manner to ensure the company hires the best people to run the business—not on the basis of the manager's association with the controlling family.

Increasingly, talented professionals are seeking additional opportunities to make the difference in businesses, and an inconsistent governance system can prevent them from doing so. Here are a few common pitfalls, making it difficult for managers to focus on performing their direct responsibilities of running company affairs:

- Uncertain criteria for promoting managers
- Absence of a merit-based pay system
- Obscure compensation schemes
- Erratic and non-transparent decision-making that impacts human resources issues and responsibilities for running company affairs

### Attracting and retaining top talent committed to the company's value system

**Natura's** leaders believe that the success of its governance is based on the commitment and engagement of all employees, at all levels, as well as on a common understanding of the company's strategy throughout the firm. To retain talented employees committed to Natura's principles and beliefs—and with the ultimate goal of improving company operations—Natura undertook a series of governance-related steps:

- Offering competitive wages and benefits
- Promoting the motivated employees who are key to the company's success
- Conducting annual employee satisfaction surveys through an independent firm since 1995

### Creating company value

**Ultrapar** became more focused on the professionalization of its management team in the early 1980s, when the concept of alignment of interests was introduced. Company leaders looked to create value for the company by retaining certain key members of the Group's management and ensuring success through succession. The introduction of executive compensation packages, which included a payment in the form of shares, was one of the key steps taken. Company owner Pery Igel initiated this pioneering concept. Igel's legacy in this regard has been significant: the granting of shares to management and aligning the interests of the executives to those of the original shareholders has helped build harmonious relationships between Igel's heirs—the controlling family shareholders—and the company's senior executives.

*"To become a true corporation—that was Pery Igel's dream. The company succeeded in achieving this dream, by implementing outstanding corporate governance practices."*

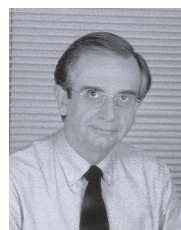


—Pedro Wongtschowski, *Ultrapar*, CEO

## 6 Achieving Better Operational Results

*“Corporate governance has been developed and molded in a modern company context, with participation of minority shareholders in a very transparent way. All this resulted in increasing its agility, level of efficiency, being modern and undoubtedly it was a very beneficial transformation to the company.”<sup>16</sup>*

—**Eduardo Borges Andrade**, CCR,  
Shareholder, Director and Chairman of  
Corporate Governance Committee



Efficient management depends on accountability of decision-makers and employees and on the timely flow of relevant information to those who need it to perform their functions. A desire to achieve better operating results and productivity is yet another strong motivation for companies to improve their corporate governance practices.

Managers, directors and shareholders are all likely to make more informed, quicker and better decisions when the company's governance structure allows them to clearly understand their respective roles and responsibilities, and when communication processes are regulated in an efficient and effective manner. This, in turn, should significantly enhance the efficiency of the financial and business operations of the company at all levels. Top quality corporate governance streamlines all of a company's business processes, and this leads to better operating performance and lower capital expenditures,<sup>17</sup> which, in turn, may contribute to the growth of sales and profits.

Numerous academic empirical studies have shown that good governance brings many improvements contributing to the better overall performance of companies.<sup>18</sup>

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<sup>16</sup> BOVESPA (2004), Como e porque tornar—se uma companhia aberta (Unofficial translation: How and why to become a public company).

<sup>17</sup> GOMPERS, P. A., ISHII, J. L., & METRICK, A. (2003). Corporate governance and equity prices. *Quarterly Journal of Economics*, 118, n. 1, pp. 107-155.

<sup>18</sup> Some examples of such studies are:

- A study of the 100 largest emerging market companies by Credit Lyonnais Securities Asia (CLSA) in 2001 showed that companies with the best corporate governance in each of a large number of emerging market countries had EVA (economic value added) scores eight percentage points higher than firms in their country average.
- A Harvard/Wharton team also found that US-based firms with better governance have faster sales growth and were more profitable than their peers.
- An ABN AMRO study (previously mentioned) showed that Brazilian firms with above-average corporate governance had ROEs (return on equity) that were 45 percent higher and net margins that were 76 percent higher than those with below-average governance practices.
- A study of S&P 500 firms by Deutsche Bank showed that companies with strong or improving corporate governance outperformed those with poor or deteriorating governance practices by about 19 percent over a two-year

By having a structured process, where rights, responsibilities and structures for decision-making are clearly described, companies are in a better position to avoid conflicts of interest and support better, informed decisions.

### Better governance as competitive differentiator

For **Atlas Eléctrica, S.A.**, the holding company of a white goods manufacturer in Costa Rica, governance improvements were motivated in part by its desire to differentiate the company from other companies in the industry operating in Costa Rica—specifically its international competitors.

Atlas, founded in a small shack in 1961, grew to be the first company to issue shares in Costa Rica's stock exchange in 1976. Corporate governance was viewed by the company's owners and management as a way to attract additional investors, given the relatively small size of Costa Rica's capital market. Company owners also saw that better governance would help the company beat out its foreign competition for local suppliers. A higher level of governance would give suppliers an additional measure of comfort in their partnership with Atlas.

### Enabling rapid action and fast decision-making

**CPFL Energia** has a complex structure, the result of combining several companies. This made it essential to set up effective and streamlined information flows, which would support efficient decision-making and problem-solving. As an electricity business, a basic input for companies and people's lives, the company also must take into consideration the risk of accidents that may stem from its activities.

Company leaders saw that good governance, including effective internal controls, would bring gains to company operations. The decision-making process at the top management and board levels needed to be structured to enable fast, effective decisions, aimed at maximizing the economic efficiency and return on invested capital. To reach this goal, seven committees—later reduced to three—were set up to assist the company's board of directors. These committees provide agility and consistency to the board's decisions. The committees explore in detail various issues to be decided by the board:

- Setting executive compensation levels
- Evaluating the overall performance of executive officers
- Assessing the risk profile and internal controls of the company and its subsidiaries
- Reviewing the quality of information feeding the board decision-making process
- Reviewing supply and services transactions involving related parties

The process, fixed in the company's shareholders' agreement, has created a consistent framework for decisions and a higher level of certainty that all aspects of an issue will be discussed or explored as necessary.

**Accountability is key.** Better operational results and clearer accountability also play an important role in enhancing a company's reputation. A company's reputation and image effectively constitute an integral, if intangible, part of its assets. Companies that respect the rights of shareholders and creditors, and ensure financial transparency and accountability, will be regarded as an advocate of investors' interests. As a result, such companies are more likely to be considered worthy corporate citizens and, accordingly, will enjoy more public confidence and goodwill.

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period. See GRANDMONT, R., GRANT, G., & SILVA, F. (2004). Beyond the numbers—corporate governance: implications for investors. *Deutsche Bank*.

This public confidence and goodwill can lead to higher trust in the company. A company's positive brand image or goodwill plays a significant role in the valuation of a company. In accounting terms, "goodwill" is the amount that the purchase price exceeds the fair value of the acquired company's assets. It is the premium one company pays to buy another.

The path to good governance is unique for each company. Ownership structure, cultural aspects, the profile of managers, risks and urgency involved are among the aspects that mold the route each company takes towards better governance.

## For Further Thought and Discussion

This chapter has identified the whys and the ways—the various categories of motivations that drive a company's quest for governance improvements. Now, consider your company's situation:

- What are your company's main motivations to improve corporate governance practices?
- What examples of the Companies Circle are most relevant to your situation?
- What are the key challenges and barriers that your company faces to improve governance?