

A Fund Manager's Perspective on Corporate Governance

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What is corporate governance?

Typical definition:

The set of processes and systems by which businesses are directed and controlled.

An alternative definition:

The set of relationships between a company's management, board, shareholders and other stakeholders that provides the structure through which corporate objectives are set, the means of attaining those objectives are specified and performance is monitored.

The private company context is unique

<u>Public Company Context</u>	<u>Private Company Context</u>
<ul style="list-style-type: none">■ Widely dispersed shareholder base■ Individual shareholders have limited power, control and business knowledge■ Management often owns minimal equity■ Often extensive administrative and overhead functions	<ul style="list-style-type: none">■ Often a concentrated shareholder base■ Shareholders often have significant power and, control and business knowledge■ Management often owns significant equity■ Often minimal administrative and overhead functions■ Company may or may not be planning to go public

- Governance in public companies is usually about ensuring that the board functions in a manner that protects shareholders
- Governance in private companies is about ensuring the company is managed to facilitate growth and efficiency
- Implication: Governance practices that make sense for public companies may or may not make sense for private companies

Many formal governance guidelines are not appropriate for private companies

<u>Guideline</u>	<u>Comments</u>
Independent directors	<ul style="list-style-type: none"> • Great if they are high quality • Practically speaking often difficult to find and recruit • In reality boards of small companies often consist of 2-3 key managers and investor representatives
Board mandate	<ul style="list-style-type: none"> • Nice, but usually implicit rather than formal
Position descriptions	<ul style="list-style-type: none"> • Private boards often don't have committees and roles of chairman and CEO are often implicit
Orientation and education	<ul style="list-style-type: none"> • Benefit rarely exceeds cost
Codes of conduct and ethics	<ul style="list-style-type: none"> • Management integrity and honesty is a critical issue in the investment decision • Due diligence delves into management's credibility and often includes background and reference checks • Codes of conduct are not a major factor but can help convey that the company culture is ethical and honest
Nomination	<ul style="list-style-type: none"> • Directors are usually only management and investor representatives so the need for nominations occurs infrequently. Formal committees and processes are somewhat unnecessary.
Compensation	<ul style="list-style-type: none"> • Limits on CEO compensation often specified in investor documentation (i.e. shareholders' agreement or debenture)
Assessment	<ul style="list-style-type: none"> • As long as the company is doing well the board is doing its job. If the company isn't doing well, the issue is usually management not the board.

But other governance guidelines are important

- Unless a company is preparing to go public, the typical public company guidelines are not the most important elements of good governance
 - Shareholders don't need the board to protect them – they can protect themselves (or are management)
- What is most important is making sure that the company is managed effectively
- Governance in this context means:
 - Aligned interests with key managers owning significant equity
 - A complete management team with all relevant functional expertise and ideally a plausible successor to the CEO
 - A culture of ethical and honest business practices and a demonstrated track record of honest dealings by key managers
 - If possible, access to advisors and mentors capable of providing assistance
 - A management team that listens to advice and seeks to include all key stakeholders in major decisions

We don't try to instill "good governance practices" – they're either there or we don't invest

In all cases the board must live up to its responsibilities

- All boards (and individual directors) have certain legal and moral duties
 - Fiduciary duty to act honestly in the best interests of the corporation
 - Duty to exercise care, skill, judgment and diligence
 - To act fairly and take into account the interests of all security holders
 - Conflicts and competing interests should be fully disclosed. Individual directors should recuse themselves from discussions and decisions when they are conflicted
 - No appropriation of corporate opportunities

Who is Penfund?

- Penfund manages money on behalf of various pension funds including:













- Penfund has been in business since 1979 and currently has about \$200 million under management
- Since our establishment, we have provided over \$2 billion of equity, senior and mezzanine financing to about 200 Canadian companies

Who is Penfund?

- Penfund is targeting investments of \$5 - \$20 million
- We have a formal co-investment arrangement which enables us to invest up to \$50 million per transaction
- We invest subordinated debt and equity in public and private companies throughout North America
- We have absolute discretion over our capital. We have no credit or investment committees
- We are employee owned and understand the entrepreneurial mindset
- We can provide indicative term sheets in 24 hours
- We can fund in 4 weeks
- Willing to pay referral fees

Selected Penfund Case Studies

	Business Description	Use of Funds
  	<ul style="list-style-type: none"> ▶ Private label producer of cat litter and other pet products ▶ Specialty retailer of pet food and supplies 	<ul style="list-style-type: none"> ▶ Shareholder reorganization ▶ Debt refinancing
   	<ul style="list-style-type: none"> ▶ Provider of business aviation services ▶ Software products for the trucking industry ▶ North America's only online auction site for fresh cut flowers ▶ Leading manufacturer of plastic interior subsystems for cars and light trucks 	<ul style="list-style-type: none"> ▶ Refinance bank facilities ▶ Refinancing and shareholder dividend ▶ Shareholder reorganization ▶ Leveraged buyout
  	<ul style="list-style-type: none"> ▶ Canada's only national provider of reverse mortgages for seniors ▶ Manufacturer of prescription foot orthotics and related products ▶ Sequencer and sub-assembler of automotive components for OEMs 	<ul style="list-style-type: none"> ▶ Finance mortgage origination costs ▶ Redemption of convertible debenture ▶ Acquisition financing

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