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# Corporate governance cannot just be an add-on

For regional businesses, the choice is to engage in reforms or court failure

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Private equity (PE) firms operating in the Mena region have a unique position among all other types of regional investors.

Unlike Sovereign Wealth Funds, family offices, or merchant groups, these firms get deeper into the fabric of their investee companies. Participating in privately held businesses, they have the opportunity to observe up close and personal their inner workings.

And due to their medium-term investment horizons (five to seven years), they have a vested interest in shouldering greater involvement at all levels. PE firms operate in a region that has a relatively new corporate culture, and where corporate governance rules are either misunderstood or misapplied.

Flawed governance is a real — not virtual — risk, since more critical than capital performance is human capital performance. In practice, some of the thorniest issues that PE firms face post-transactions relate to matters of governance. These could be the board's composition, conflicts of interest, applying proper norms for hiring and rewarding employees, transparency, disclosure, accountability, financial discipline, etc.

Some investors claim that sound governance does not necessarily equate to a strong financial performance. Dictatorships are, after all, very efficient governance machines that take swift decisions without delays or procrastination.

Playing the devil's advocate on this argument one step further, one could claim that there is no guarantee that well-governed companies will generate better annual results.

However, there evidently is a positive correlation between good governance in public companies and good stock performance. Just as there is historical evidence that democracies tend to last longer than autocracies.

Should this phenomenon that is applicable on publicly listed companies remain alien to private companies in the Middle East? After all, many PE-backed companies are simply public-companies-in-waiting.

**Factors**

This dilemma takes another twist in the context of the Mena region due to several factors. Here are but a few:

• For one, private companies are subjected to a minimalist regime of transparency and disclosure apart from the occasional updates in the commercial registry. Audited financial statements are not rigorously filed, if at all, and seldom with auditors' notes that permit a better understanding of results. This tends to make corporations complacent, opaque and unwilling to share material developments about their corporate structures.

• The executive authority of a CEO in a private company, unless being the founder, takes a back seat to that of the chairman (usually the patriarchal founder of the business). The chairman's role is blurred.

Instead of overseeing the proper functioning of the board, a chairman's role in regional companies crosses into executive decision-making, which in turn renders the CEO a high-ranking employee, with little incentive to take initiatives or bring the company into new dimensions.

• Board composition is generally compromised at two levels: members' independence and the respect of fiduciary duty. Boards are usually filled with familiar, and friendly faces, or by representatives of shareholders hence, the lack of independent views and the greater risk of conflicts of interest.

As for fiduciary duty, board members are entrusted with acting on behalf of the company and all its shareholders, not necessarily of those who nominated the board members; A principle that is hardly followed.

• Succession planning is an afterthought and depends not on the health of the company but of the person in charge. If a particular chairman or CEO is enjoying good health, then the issue of succession is rarely brought up in corporate planning sessions.

In fact some view that succession planning is a means of plotting the removal — not the gradual replacement — of the person at the helm. For such reasons succession planning, which is almost mandatory in all corporate settings, is an odd subject in the context of the Mena region.

**Poor governance**

Against this background, there is a strong belief among regional PE firms that poorly governed companies are more prone to failures, and least prepared for an exit. Sub-optimal corporate governance causes financially sound companies to incur losses and face failures.

In that same vein, profitable companies cannot be sold at high premiums if they lack strong foundations in corporate governance.

Scandals that have ripped through the corporate fabric of developed countries have been man-made, self-inflicted and avertable. All the talk about excessive leverage, toxic assets and exotic financial instruments is the handy work of the bankers, experts and advisers who concocted them in the first place.

They are the fruits of poor governance by management who pursued short-term benefits, and of lack of supervision by boards to curb excessive behaviour.

Left without any judicial or legislative support, PE firms in the Mena need to reassess their investment preconditions and prepare themselves for a fight to better corporate governance in all of their investments.

Their responsible advice to all of their would-be investee companies, from the outset, must be: reform or fail.

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