Doing Well While Acting Good

Benefits of Good Governance, Insights from MENA

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This paper addresses the following MENA-focused questions regarding corporate governance: How does the MENA governance framework compare to the developed and other emerging regions? What role regional PE firms play in advocating the implementation and merits of corporate governance? Are there tangible benefits for implementing good corporate governance practices in the MENA?

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I. Introduction

An increasing attention has been given to corporate governance in the past decade as scandals have exposed grave governance issues within companies. These concerns were exacerbated during the 2008 crisis which exposed weak controls at many firms. While there were multiple causes to the scandals, the lack of efficient corporate governance was pointed out as a key issue, Enron and WorldCom being perfect examples (ultimately leading to the adoption of the Sarbanes-Oxley Act of 2002 in the United States, a sweeping corporate governance regulation). Citi's ineffective handling of their mortgage-related holdings during the 2008 crisis is yet another example of lack of efficient corporate governance. As described in a New York Times article[1], Citi's CEO discovered in 2007 that his bank owned about $43 billion in mortgage-related assets and when he asked the head of trading if everything was ok, he took his positive answer as a definitive one. However, "*normally, a big bank would never allow the word of just one executive to carry so much weight. Instead, it would have its risk managers aggressively look over any shoulder and guard against trading or lending excesses. But many Citigroup insiders say the bank's risk managers never investigated deeply enough."* Citi lost more than $65 billion in the financial crisis, more than half of that stemming from mortgage-related securities. A report by the *"Federal Reserve took the bank to task for poor oversight and risk controls in a report it sent to Citigroup."* Had Citi had efficient governance systems and processes, they would have probably seen the red flags and potentially cut their losses.

Corporate governance shortcomings were alas not restricted to developed markets. Developing markets have witnessed abuses of shareholders' rights caused directly by lax corporate governance standards. The well-publicized cases of Bumi plc - the Indonesian mining conglomerate; and Damas - the UAE-based jewelry holding company, scream of failures in corporate governance spanning from lack of independence of Boards to failing in duties to minority shareholders. The two episodes illustrate the challenge of family-controlled, emerging markets' businesses willing to integrate the global economy for greater liquidity but not greater transparency.

[1] The New York Times - *Citigroup Saw No Red Flags Even as It Made Bolder Bets* (Eric Dash and Julie Creswell, November 22, 2008) (http://www.nytimes.com/2008/11/23/business/23citi.html?pagewanted=all)

Corporate Governance is defined by the Organization for Economic Co-operation and Development[2] ("OECD") as the *"procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the Board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making."*

According to this definition, it is through corporate governance processes and procedures that a company is run. Entities such as the Institutional Investors Research Center ("IRRC") have defined governance provisions[3] that have been used in many papers to measure the impact of the implementation or not of these provisions on a company's performance. (Exhibit A for a list of IRRC provisions)

In their paper *"Corporate Governance and Equity Prices" [2003]*[4], Gompers, Ishii and Metrick, looked at 1500 companies per year during the 1990's and established the existence of a strong correlation between good governance and company performance. Leveraging the 24 provisions that the IRRC defined as a proxy for the level of shareholders right, they developed a *"Governance Index"* that ranks companies relatively to how much power is given to managers versus shareholders. The provisions include elements such as the *"Bylaw and Charter amendment limitations"* which limit shareholders' ability to amend the governing documents of the corporation. Another provision is the *"classified (or staggered) Board"* in which *"the directors are placed into different classes and serve overlapping terms. Since only part of the Board can be replaced each year, an outsider who gains control of a corporation may have to wait a few years before being able to gain control of the Board"*[5]. The study shows that an investment strategy that bought firms in the lowest decile of the index (strongest shareholders rights) and sold firms in the highest decile of the index (weakest shareholders rights) would have earned abnormal returns of 8.5% per year during the sample period. They found that firms with stronger shareholder rights had higher firm value (when considering Tobin's Q results), higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions. Similarly, companies that had weak shareholders

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[2] OECD Glossary of Statistical Terms – Corporate Governance (http://stats.oecd.org/glossary/detail.asp?ID=6778)
[3] Corporate Governance and Equity Prices - Quarterly Journal of Economics 118(1), February 2003, 107-155
[4] Corporate Governance and Equity Prices - Quarterly Journal of Economics 118(1), February 2003, 107-155
[5] Corporate Governance and Equity Prices - Quarterly Journal of Economics 118(1), February 2003, 107-155

rights were less profitable and had lower sales growth than other companies in their industry. Thus the authors were able to show a positive correlation between corporate governance and performance (without necessarily proving causality, that is, that good corporate governance caused the good returns).

In 2000, Paul Coombes and Mark Watson surveyed for McKinsey Quarterly[6] 200 institutional investors (total assets under management of $3.25 trillion) in developed (US and Europe) and emerging markets (Asia and Latin America). They sought to understand how shareholders perceive and value corporate governance. They found that three-quarters of investors consider Board practices as important as financial performance when they evaluate companies for investment. Over 80% of the investors say that they would pay more for the shares of a well-governed company than for those of a poorly governed one with a comparable financial performance. A well-governed company was defined as one that has a majority of outside directors with no management ties on its Board, undertakes formal evaluations of directors, and is responsive to requests from investors for information on governance issues. Directors should also hold significant shareholdings in the company, and a large part of their pay should come in the form of stock options. The study shows that investors would be willing to pay an even higher premium when it comes to companies that are in developing markets versus in developed ones. This is probably due to developed countries having higher accounting standards and a much more developed regulatory environment making investors more comfortable to rely on public regulation. In emerging markets on the other hand, investors will try to identify companies with strong corporate governance that may counterbalance the lack of efficient regulation. These results should ultimately serve as an incentive to companies to have better corporate governance which will allow them to attract and retain capital.

In the MENA region[7], the World Bank's International Finance Corporation ("IFC") conducted a study on 11 companies that made governance improvements in the past 6 years assessing the impact that these changes have had. Overall, companies reported highly positive impacts as a result of said changes. Companies made improvements at all levels of the

[6] *"Three Surveys on Corporate Governance"* – Paul Coombes and Mark Watson – The McKinsey Quarterly 2000 number 4: Asia Revalued
[7] IFC Advisory Services in the Middle East and North Africa, *"Corporate Governance Success Stories"*, 2010

organization from the Board to the management structures. The changes that were made cover several aspects of corporate governance such as having more clarity on the role of the Board, defining processes and procedures for the Board, setting up Board committees, etc. This has had significant impacts on the involved companies, as they reported:

- Having better access to capital as investors, creditors and other debtors gained added assurance in the companies' future.
- Significant improvements in reputation with shareholders, investors, customers and business partners.
- Improvement in their profits/results as they took actions to control costs.
- Enhanced organizational efficiency, by establishing more formal processes and controls and clarifying roles and responsibilities among others.
- Better response to global recession and credit squeeze by having better risk management and Board stewardship.
- Enhanced sustainability as corporate governance helped setup better succession planning.

In that same paper, IFC interviewed three active Private Equity ("PE") firms in the region to better understand their approach to corporate governance. The unanimous response was that corporate governance was essential to value creation and hence is a crucial part of their process. PE firms are indeed increasingly focused on having good corporate governance for themselves as well as for their portfolio companies. For instance, the Private Equity Growth Capital Council ("PEGCC "), a trade organization representing the industry in the US, issued guidelines for responsible investments which incorporate among others governance issues in investment decision-making.[8] Many MENA PE firms either implement some form of, or like GrowthGate Capital adhere fully to, the PEGCC guidelines.

Building on earlier work, the goal of this paper is to understand:

- How does the MENA governance framework compare to the developed and other emerging regions?
- What role regional PE firms play in advocating the implementation and merits of corporate governance?
- Are there tangible benefits for implementing good corporate governance practices in the MENA?

[8] Blackstone website: http://www.blackstone.com/the-firm/transparency-disclosure, accessed on May 1st 2013.

II. Development of Corporate Governance Codes across MENA and Benchmarking against OECD Codes

The issuance of Corporate Governance Codes (the "Codes") is a recent phenomenon in the MENA region. Between 2005 and 2009, 11 Codes were introduced by national regulators, in addition to specialized guidance for state-owned enterprises, banks and family-owned companies[9]. Today 14 of the 17 MENA economies have a corporate governance code of some description[10]. The frameworks address, to various degrees, many key topics of interest in corporate governance: Board composition, Independence of Boards, Board training and development, role of an Audit Committee, Risk Management, remuneration of the Board, and Corporate Social Responsibility. But the fact that only the UAE, Jordan, Saudi Arabia, Oman and Qatar have made their Codes mandatory is illustrative of the slow pace of such movement in MENA and the non-priority position it still garners.

Most of MENA countries are following a voluntary "comply or explain" approach, which is similar to the provisions of the Combined Code in the United Kingdom ("UK)" (or the UK Corporate Governance Code of 2012[11]). The Combined Code follows a "principles-based" approach to corporate governance, which contrasts from the more detailed "rules-based" regimes in the United States (and China). As per this approach, regulators set out a code (rather than binding laws) which listed companies may either comply with, or if they do not comply, explain publicly why they do not.

The Combined Code sets minimum standards for companies in their audit committees, remuneration committees and recommendations for how good companies should divide authority on their Boards. The "comply or explain" approach has been in operation since the Combined Code’s beginnings and is the foundation of the Combined Code’s flexibility. It is strongly supported by both companies and shareholders, and is seen globally as the touchstone of corporate governance regimes. However, there are crucial differences between the UK and MENA which might merit a different mandatory and rules-based approach to corporate governance implementation.

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[9] OECD Journal- Financial Market Trends , *The Second Wave of Corporate Governance in MENA, Alissa Koldertsova, February 2011*
[10] Press articles, Corporate governance (Hawkamah) in a developing Middle East: *More than window dressing*, May 2013
[11] Financial Reporting Council, UK Corporate Governance Code, September 2012

Comparison of Corporate Governance Codes in the MENA Region

Country	Year of last issue	Separation of CEO / Chair	Majority Independent / Some NEDs required[1]	Three subcommittees[2]	Board Evaluation
MENA					
Bahrain	2010	Yes	Some NEDs required	Yes	Yes
Egypt	2006	Yes	Some NEDs required	Audit & Remuneration	No
Oman	2002	Yes	Some NEDs required	Audit	No
Qatar	2009	Yes	Some NEDs required	Yes	No
Saudi Arabia	2006	Yes	Some NEDs required	Yes	No
UAE	2007	Yes	Some NEDs required	Audit & Remuneration	No
North America and Europe					
US	2006	No	Majority Independent	Yes	No
Canada	2010	Yes	Majority Independent	Yes	No
UK	2010	Yes	Majority Independent	Yes	Yes
Spain	2006	No	No Majority Independent BoD required	Yes	Yes
Switzerland	2008	No	Some NEDs required	Yes	Yes
Turkey	2005	Yes	Some NEDs required	Yes	Yes
Russia	2002	No	No Majority Independent BoD required	Audit & Remuneration	Yes

1. NED refers to Non-Executive Board of Directors
2. Three subcommittees refer to Audit, Remuneration and Board Nomination

Source: Hawkamah Institute for Corporate Governance; Web article: http://www.palgrave.com/finance/padgett/students/casestudies/chapter7.pdf

Understanding of the Purpose of Corporate Governance

In most developed countries, such as the UK, the role of the Board is seen as to *"facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company"*.[12] Widespread understanding about the over-arching goals of the Combined Code helps implementing a principles-based approach. However, the 2008 Hawkamah-IFC survey of five Gulf Cooperation Council ("GCC") countries that have adopted similar Codes – Saudi Arabia, Bahrain, Qatar, Oman and the UAE – do not share the same level of understanding of the purpose of corporate governance measures, which impedes compliance with a principles-based approach.[13]

[12] Financial Reporting Council, The UK Corporate Governance Code, September 2012
[13] Hawkamah Institute for Corporate Governance, Hawkamah Brief on Corporate Governance Codes of the GCC[13]

This is also evidenced in the survey[14] of 200 listed companies conducted by the GCC Board of Directors Institute in 2011 that showed 40% of respondents reporting increasing ambiguity about one of the most prominent purposes of corporate governance – the relationship and division of roles between Boards and management.

Understanding of the Role of the Board and Other Officers

Codes in MENA explain in considerable detail the role of the Board. They describe it as one who has a fiduciary duty towards shareholders to oversee management and help implement appropriate risk and control procedures. The Board's role is one of oversight, while management takes day-to-day decisions of running the business. In spirit, this is very similar to the Combined Code of the UK and to others in many developed countries.

However, there is a major gap in on-the-ground understanding of the Board's supervisory role and the letter of the Codes in MENA region. The 2008 Hawkamah-IFC survey[15] found that the role of the Board is often misunderstood in the MENA region. According to the survey, 89.9% of MENA banks and listed companies stated that the Board, and not management, was responsible for setting strategic goals. This is because Board members' actions continue to show a bias towards complying with the company's majority shareholders. These are often the founders of the business and the appointers of the Board[16]. This continues to be an issue despite an increase in the proportion of independent Board members in MENA based companies (64% according to a survey[17] of 200 listed GCC companies conducted by the GCC Board of Directors Institute in 2011. The figure in the same study was 46% in 2009). Our interviews with PE firms suggest that this often results in a power struggle between CEOs and their Boards in the MENA region.

Moreover, misperceptions around the role of the Board are also exacerbated by the legal framework in many MENA countries where the law often stipulates that in order for a director to hold a seat, he/she must also own shares in the company[18]. This very basic misunderstanding calls for a

[14] GCC Board of Directors Institute, *Embarking on a Journey – A Review of Board Effectiveness in the Gulf (2011)*
[15] Hawkamah Institute for Corporate Governance, Hawkamah Brief on Corporate Governance Codes of the GCC
[16] GCC Board of Directors Institute, *Embarking on a Journey – A Review of Board Effectiveness in the Gulf (2011)*
[17] GCC Board of Directors Institute, Embarking on a Journey – A Review of Board Effectiveness in the Gulf (2011)
[18] Center For International Private Enterprise Global Corporate Governance Forum , Advancing Corporate Governance in the Middle East and North Africa: Stories and Solutions (February 2011)

considerable amount of education among shareholders, financiers, market analysts and the broader business community in the MENA region about the role of the Board. Without such an educational approach, it is difficult to see a voluntary, principles-based approach succeeding.

Lack of transparency and accountability

Like many other emerging markets (including the BRICs), countries in MENA have a relatively high proportion of family-owned businesses (medium to large family businesses constitute roughly 75% of the private sector in the GCC[19]). Because the voluntary "comply or explain" approach practiced in many MENA countries requires relatively little disclosure from private firms, most have stuck to their old habits of providing minimal voluntary filings. There might also be other ulterior motives for non-disclosure by privately-held firms (e.g.: concealing ownership %, names of shareholders etc.). Even publicly listed companies show innate resistance to disclosure. For instance, in a 2011 report by the GCC Board of Directors Institute, only 43% out of 200 publicly listed companies that were surveyed provided an annual report on their website, or provided a copy when requested.[20]

This environment of minimal regulation is typical of the cultural context of developing markets that is generally reluctant to non-coercively disclose potentially sensitive commercial information to the public.

This leads to a lack of transparency and accountability which makes it difficult to encourage implementation of a voluntary, principles-based approach to corporate governance. While having outside investors in a company (e.g. PE firms) can lead to better reporting standards, the impact is limited as these investors typically only hold a minority stake in the business as shown by our surveys and interviews. The absence of any mandatory rule for applying the International Financial Reporting Standards ("IFRS") has led many local companies to follow local (or no) accounting rules. This impedes a PE firm's investment decision-making process forcing them to apply painstaking forensic accounting during the due diligence.

[19] Al-Masah Capital Limited, MENA Family Businesses: The Real Power Brokers? (April 2011)
[20] GCC Board of Directors Institute, Embarking on a Journey – A Review of Board Effectiveness in the Gulf (2011)

Because of the reasons identified above, it is difficult to see how the existing corporate governance frameworks within the specific context of the MENA region can encourage good corporate governance standards among PE portfolio companies. It could be argued, therefore, that a compulsory, exhaustive rules-based framework for a few years is necessary to lay the basic groundwork for good, widespread corporate governance practice in MENA. This can be seen as a period of transition before a voluntary, principles-based approach similar to the Combined Code is ultimately adopted. The model code to-be adopted could reduce onerous regulation and at the same time set out principles and provisions that are flexible enough to guide corporate governance practices under all economic cycles.

In the meantime PE firm that have the ‘carrot’ of investments will be required to use the ‘stick’ of proper corporate governance at three levels: (i) pre-entry as a condition to invest (e.g., converting to IFRS, implementing reporting systems), (ii) post-entry as a means of monitoring (even minority stakes can be accompanied by ‘influence rights’ to guide and yield corporate changes especially at the Board & committees levels and in redefine the role & interaction between Board and CEO); and (iii) pre-sale as part of the exit planning process in order to ‘clean house’ prior to the portfolio company engage in a sale whether public or private.

III. Challenges in Implementing Good Corporate Governance Practices

In the earlier section we mentioned some of the key challenges – understanding the purpose of corporate governance, the role of the Board and other executive officers, and lack of transparency and accountability – that explain why a principles-based corporate governance regime similar to some OECD countries (such as the UK) might not work in MENA. In the following section, we explain further challenges that impact good corporate governance practice in the region.

Concentration of family-owned businesses

In a study on disclosure of compliance policies done by the Red Flag Group[21], it was reported that utilities, transportation and engineering groups had a more transparent approach while family-owned conglomerates were the most opaque. The concentration of such family-owned businesses is a feature of corporate MENA that poses three main problems:

- First, family-owned businesses often follow a patriarchal decision making process that is centralized around the founding / majority shareholders of the company.
- Second, there is an issue of perception at play here – corporate governance is considered by many family businesses to be the purview of large, listed companies, despite the fact that strong standards could lead to written procedures around intergenerational transfer of control over the family business and reduce conflicts within families[22].
- Third, in our interviews with PE firms in the region, we discovered a reluctance to change even after such family owned businesses receive cash injections from investors who are committed to improving corporate governance standards in their portfolio companies. The main reason quoted for this is the inability to see a link between better corporate governance practices and stronger financial performance (*"If it isn't broke, why fix it"*).

Maturity of financial markets

The contraction in the financial services sector in the global financial crisis led to gaps in the maturity of financial markets which have impeded progress in corporate governance standards. Based on anecdotal evidence from the PE firms we interviewed, one of the biggest areas where this is evident is in the decline in the number of research analysts covering companies as reputable financial services firms look to cut costs by downsizing research departments (research departments are a drag on investment banking profits when brokerage on sales of securities is hit by a downturn in financial markets)[23]. As a result, opacity in financial reporting

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[21] Press articles: http://www.ft.com/intl/cms/s/0/53b79214-a5ab-11e2-9b77-00144feabdc0.html#axzz2Rz36ZBLK

[22] Center For International Private Enterprise Global Corporate Governance Forum , *Advancing Corporate Governance in the Middle East and North Africa: Stories and Solutions (February 2011)*

[23] Reuters website, September 2011,(http://www.reuters.com/article/2011/09/18/us-mena-banks-jobs-idUSTRE78H0WG20110918)

and lack of guidance around strategy, which previously would have been spotted by research analysts, has increasingly gone unchallenged.

Even at the height of the financial activity, no CEO was subjected to the pressures of an 'Analysts' Call' as is the case in more developed markets. Management in public companies is only subject to scrutiny and public accountability at General Assemblies of Shareholders. In such forums serious and less-serious claims and allegations have been leveled at management by shareholders as their only means to hold the company's overseers accountable for their actions. Thus the role of equity analysts in MENA has been compromised because of the cultural bias towards resolving matters 'behind closed doors' and the reluctance of large investment banks to irk or embarrass public companies by posing daring questions and losing lucrative business deals.

The role of independent financial analysts is even more pronounced in the MENA region, because of the high amount of overlap between Board members and founders of companies[24]. Respondents in our interviews mentioned this as a particular area of concern in corporate governance.

Government backed businesses

Large sections of the economic landscape in MENA remain under government ownership (e.g., natural resources, national infrastructure, utilities and power generation companies, majority of telecoms and large banks). As a result, the space for private companies is limited: less than one-third of the number of private companies per capita in Eastern Europe[25]. State owned entities usually have better systems and resources in place to produce transparency in financial reporting relative to most small medium-sized family businesses. However, bureaucratic legacies, slow pace of reforms and the quality of decision making often means that, despite the resources and ability of State-owned entities to implement transparent financial reporting, its implementation is often not realized. This sets a 'bad example' for private sector companies to follow, which in turn, do not feel compelled to adopt voluntary disclosure & transparency principles.

[24] Center For International Private Enterprise Global Corporate Governance Forum , *Advancing Corporate Governance in the Middle East and North Africa: Stories and Solutions (February 2011)*
[25] The Economist, Feb 25 2012, http://www.economist.com/node/21548153

Lack of proper systems and procedures

Lack of written procedures is just one example of how paucity of proper reporting systems is a challenge for corporate governance in MENA. This is particularly true for small / medium sized businesses, where scarcity of resources and operating in an oral-based culture preclude managers from realizing the benefits effective decision making and reporting. These procedures and policies should include: corporate governance structure of the company, methods to ensure that corporate legal and regulatory responsibilities are being met, executive remuneration policies, and a code of conduct, among other items.[26]

IV. Notable Developments in Improving Corporate Governance

At the same time, the recent period has seen some changes for the better. An OECD Journal on Middle East Corporate Governance (2011)[27] surveyed 17 MENA countries and found that only three countries did not have any corporate governance codes in place. This shows the positive developments in corporate governance in MENA in the aftermath of the 2006[28] stock market crash, which capped the first wave of developments in corporate governance standards in early 2000's in MENA. The Lebanese Transparency Association (2006) and Moroccan Corporate Governance Task force (2008) introduced specialized guidelines for family-owned small and medium-size enterprises, while the Jordanian, Palestinian and the Emirati regulators have also introduced codes for banks[29]. Perhaps the most positive sign is the role of the private sector in initiating some of these frameworks. In Algeria for instance, the Corporate Governance Commission, which drafted the Code in 2009, was formulated as a grassroots initiative by the private sector.[30] The Pearl Initiative, founded in 2010, is another example of a private sector-led not-for-profit organization set up to improve transparency, accountability and business practices in the GCC.[31]

[26] Center For International Private Enterprise Global Corporate Governance Forum , *Advancing Corporate Governance in the Middle East and North Africa: Stories and Solutions (February 2011)*
[27] OECD Journal- Financial Market Trends , *The Second Wave of Corporate Governance in MENA, Alissa Koldertsova (February 2011)*
[28] Grant Thornton, *Middle East: Towards Innovation and Transparency (2008)*
[29] OECD Journal- Financial Market Trends , *The Second Wave of Corporate Governance in MENA, Alissa Koldertsova (February 2011)*
[30] OECD Journal- Financial Market Trends , *The Second Wave of Corporate Governance in MENA, Alissa Koldertsova (February 2011)*
[31] Pearl Initiative website: http://www.pearlinitiative.org/

Rise of more specialized organizations advocating the merits of good governance

While the first wave of development in corporate governance was based on getting baseline codes in place, the second wave focuses on the rise of more specialized organizations advocating the merits of good governance and lobbying for establishment of codes, in addition to more specialized industry specific standards being developed. In the past several years, at least four new institutes of corporate governance or institutes of directors have been established.[32]

The launch of institutes such as the Egyptian Institute of Directors (first in the region to introduce a governance code targeted specifically at state-owned entities based on OECD Guidelines) and the Hawkamah Institute of Corporate Governance further amplified these positive developments. Another prominent example is 'The Pearl Initiative', a not-for-profit organization set up to improve transparency, accountability and business practices in the Arab world. It is a growing regional membership network of business leaders committed to driving joint action and sharing knowledge and experience. The Pearl Initiative has been developed in cooperation with the United Nations Office for Partnerships.

Because of the lobbying efforts of such organizations, the focus has now shifted from issuance of corporate governance to one of implementation and clarification of rules. For example, the Saudi Capital Market Authority has, for instance, recently amended the definition of an "independent Board member", clarifying that the ownership of 5% or more of a company by a member of the Board will be considered inconsistent with independence[33].

Development of Governance Monitoring indices

The lobbying efforts of specialized institutes in the second wave of corporate governance in MENA have also resulted in the development of governance indices. These aim to develop empirical proof of the importance of strong corporate governance practices in leading to financial returns. For example, Standard & Poor's and Hawkamah have joined together to create an

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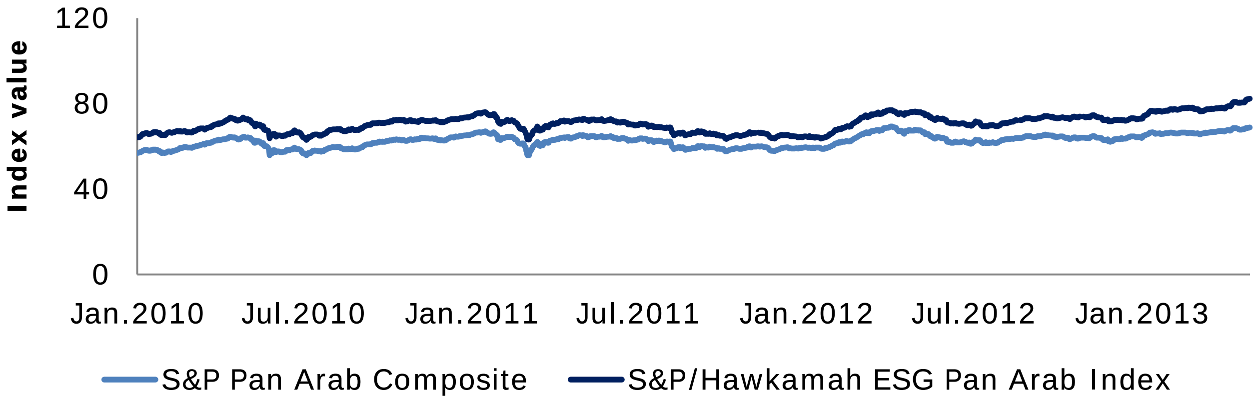
[32] Center For International Private Enterprise Global Corporate Governance Forum , Advancing Corporate Governance in the Middle East and North Africa: Stories and Solutions (February 2011)
[33] OECD Journal- Financial Market Trends , *The Second Wave of Corporate Governance in MENA, Alissa Koldertsova (February 2011)*

Environment, Social and Governance ("ESG") index for the Pan-Arab region. This index seeks to track the stock market performance of those companies that have demonstrated superiority in the areas of environmental, social and corporate governance responsibility. Linking stock market performance to ESG is, perhaps, the most effective way to highlight the importance of good governance.

Performance of S&P/Hawkamah ESG Pan Arab Index



[34]

Increased use of Advisory Boards

There are several other positive developments in corporate governance standards. One has been the increasing use of Advisory Boards to complement formal Board of Directors. The purpose of the Advisory Board is to plug gaps in management expertise without affecting the governance, ownership, and power structures of the firm. As more trust is built between the advisory Board members and regular Board directors, members of the advisory group can be invited to join as non-executive directors, thereby avoiding any issues of succession planning.

Greater emphasis of PE funds on corporate governance

Another positive development has been the trend among PE investors in MENA to move from a conservative style of investing to a more activist approach. Such firms (as indicated by our interviews and surveys) see good corporate governance practices as a key factor in enhancing their reputations. Their due diligence and investment decision criteria, therefore, focuses on having the right management and Board structure in place (even

[34] Source: S&P Dow Jones Indices

if the systems of reporting by portfolio firms are sometimes less than ideal). This increased involvement of PE firms has not gone unnoticed with specialized organizations either – for instance, Hawkamah recently announced the re-launch of its Private Equity Task Force with the aim of helping firms develop corporate governance practices in their portfolio companies.[35]

All the PE firms we surveyed as part of our study reported active monitoring of corporate governance and reporting standards imposed by them on their portfolio companies through appointing independent directors and having their own investment professionals take Board seats. In our interviews, PE firms also reported an improvement in the talent of their own investment professionals which has brought an increased rigor in monitoring and reporting standards of portfolio companies in addition to better coordination with investees in devising company strategy and commercial decisions.

Private companies in MENA have been used to informal governance practices illustrated by the absence of clear reporting lines, or management by results, and Boards without defined agendas or even minuted meetings. Furthermore, a common mingling of personal and corporate finances, encouraged by bank lending practices, has led in many instances to entangled accounts.

GrowthGate Capital has experienced similar issues with a portfolio company where it has held a strategic minority stake for around five years. During this time, GrowthGate Capital helped the company in making several governance improvements (such as adding three independent Board members, including a Chairman) and particularly addressed couple of governance issues.

The first governance issue related to personal guarantees and name-lending. The company had long been relying on personal guarantees of the founders to access bank loans. This in turn led management to exert minimal efforts in preparing detailed forecasts that are normally required by lending institutions. As the company grew, its financing needs could no longer be satisfied by personal guarantees. GrowthGate Capital's involvement helped the firm respond to this need by hiring a new CFO, creating "bankable documents", and introducing rigor in internal risk management. As a result,

[35] Press Articles, Zawya (*May 2013*)

all banks eventually approved the granting/renewal of facilities at the same previous terms. From a corporate governance perspective, these measures also leveled the playing field between founding and non-founding shareholders in terms of personal liabilities (i.e., founders were freed from the unusual burden of shouldering alone the risks of personal collateral).

The second governance issue was in relation to an acquisition of a target which was owned by some of the existing directors of the portfolio company, thereby creating a potential conflict of interest. GrowthGate Capital's solution included separating the conflicted Board members from participating in reviewing the valuation, structuring and negotiation of the transaction; appointing a GrowthGate Capital Board member with no conflict of interest to assist the CEO and his team in closing the transaction; using independent third party advisers assist in due diligence; and leading negotiations on behalf of the company as a non-executive member.

V. PE firms, a Catalyst for Regional Corporate Governance

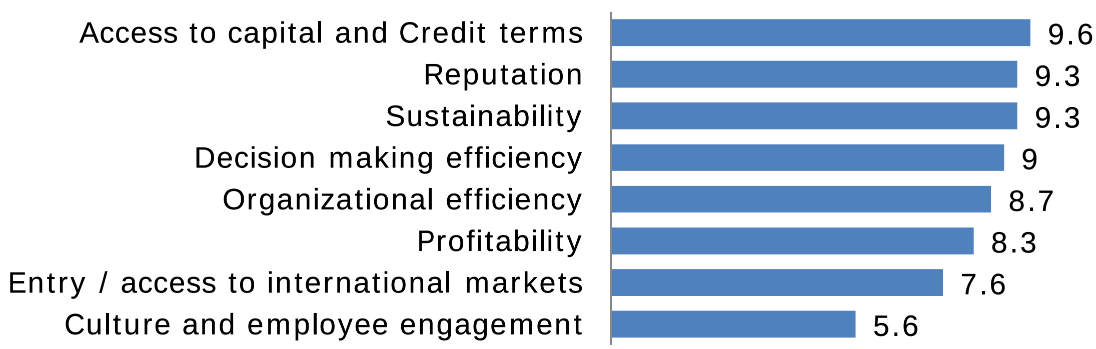
To assess the importance of corporate governance for PE firms in the MENA region, we conducted 12 interviews with top regional and international PE managers as well as intermediaries in the region.

All interviewed PE firms indicated that corporate governance bears significant importance in their investments. Although PE firms in the MENA region do not necessarily pay more for firms with good corporate governance, bad corporate governance is in general considered a deal breaker. In addition, on a scale from 1 to 5, tangible benefits resulting from good corporate governance were rated 4.75[36]. In fact, PE firms reported that corporate governance results in better access to capital and enhanced financial performance. PE firms investing in mid-market companies also indicated they pay particular attention to corporate governance as a lever to create value for their portfolio companies.

[36] 1 being no benefits and 5 most benefits

The surveyed PE firms indicated that they focused mainly on improving Board effectiveness and implementing better systems and processes including reporting and transparency measures. Four funds also considered splitting executive and oversight roles and enhancing decision processes as important. The PE firms we surveyed further indicated that they are increasingly monitoring portfolio companies by either placing a person at the company or reviewing and discussing results and concerns on a quarterly basis. While the data sample we got from interviews and survey is not large enough to build causality, PE firms reported the following improvements after introducing good corporate governance measure to their portfolio companies. (Exhibit B details the steps taken by active PE firms to improve corporate governance).

Effect of Improved Corporate Governance (Scale from 1 to 10[37])



Case in point, GrowthGate Capital reported substantial benefits from implementing good corporate governance in their portfolio companies. For example, by taking steps like separating the role of Chairman and the CEO, empowering & incentivizing key members of the senior management team and making restructuring initiatives such as defining adequately the senior officers' roles, one of GrowthGate Capital's portfolio company doubled its revenues and EBITDA in 5 years. This occurred in a period of economic crisis and slow growth in the industry. GrowthGate Capital specifically cites the empowerment & performance-base remuneration of senior execs and the adequate definition of their role as the chief driver for such impressive growth[38].

[37] 1 little effect, 5 some enhancements, 10 maximum enhancements
[38] Source: Case studies provided by GrowthGate Capital, May 2013

In another portfolio company where it has a minority stake, GrowthGate Capital lobbied for the appointment of an independent Chairman with extensive experience in the underlying sector and, as a result, the portfolio company experienced several benefits. These benefits included among others, increased attendance and active participation at Board meetings, setting well-defined agendas, making crisp presentations, and improved preparation of analysis, results and forecasts by the finance team[39].

While most general partners reported they put a lot of emphasis on corporate governance before and after acquisition, the limited partners we interviewed were more skeptical, acknowledging that while some general partners focus on corporate governance, others don't. Furthermore, some limited partners claimed that investing in growth equity transactions (most deals in the MENA region are growth equity with very little leveraged buyout activity) in high-growth industries would result in high-returns irrespective of corporate governance, making PE firms less incentivized to implement good governance measures.

Interviewed intermediaries mentioned that corporate governance has been getting traction in the region for several reasons:

- Regional PE firms recognize the benefits of good corporate governance, and hence are putting more focus and emphasis on it
- Regional PE firms are also looking to invest in other emerging regions, as well as in developed markets, and therefore are looking to develop a strong reputation as they seek access to new markets
- Regional PE firms are opening up to foreign LPs that are pushing for good governance as a common practice, similar to what happens in more developed markets
- Many groups felt that as MENA-based PE firms attract talent from developed markets and developed market PE groups potentially play a more active investment role, there will be a greater focus on good governance.

[39] Case studies provided by GrowthGate Capital, May 2013

On another hand, it is possible to overstate the progress made. Many smaller regional PE firms are yet to consider corporate governance as a key factor in their investment cycle. Indeed, some groups, facing the need to deploy quickly a significant committed capital that hasn't been drawn, seem to be turning a blind eye to good governance when making investment decisions.

All interviewed PE firms stated that they would not compromise on corporate governance in MENA when compared to investments in other parts of the world. However, because of high opacity in the region, PE firms aren't always able to address governance issues prior to investing.

This is exacerbated by the fact that most companies in the region are either state-owned or family-owned[40], which is creating several challenges such as:

- Reluctance to give-up control and majority stakes leading to minority ownership for PE firms which is hindering their ability to enforce good governance
- Lack of independence of the Board with regard to management, as well as lack of sufficient expertise on the Board
- Limited transparency and disclosures
- Inefficient succession planning

Other challenges that PE companies face were also mentioned such as:

- Cultural resistance
- Management resistance to change
- Limited systems, resources and information to implement good corporate governance especially in small companies
- Weak regulations and difficult litigation resolution
- Lack of effective implementation of regulation
- Lack of understanding and knowledge of best practices
- Limited IPO activity: instead, most exits are to strategic buyers that put less emphasis on good governance

[40] Based on interviews with PE funds and intermediaries, April 2013

Active PE firms in MENA are gradually addressing these challenges by enhancing Board compositions and introducing independent members and industry veterans who can add vision, and experience. Also PE firms are introducing other measures such as separating roles of chairman and CEO and expanding the role of the CEOs by giving them more authority while making sure they are held accountable. Finally, PE firms are advocating protection of shareholders rights through adoption of voluntary disclosure and transparency measures (like bi-annual reports to shareholders), quarterly Board meetings, introduction of rules and disclosures practices addressing conflict of interest, and getting external auditors and consultant who can provide independent reports and ensure proper functioning of corporate governance.

In summary, PE firms recognize the benefits of corporate governance and all the established large PE firms pursue activist strategies and aim to implement best practices on that front. In addition, large PE firms consider good corporate governance key for closing deals. Although there are many challenges to implement good practices in the MENA region, PE firms that managed to do so were able to reap significant benefits. While it is difficult to isolate and quantify the impact of corporate governance benefits all PE firms reported enhanced financial results, access to capital and easier exits.

Looking forward, the picture looks bright. Many recent initiatives driven by public sector, non-profit and private sector are leading to a better corporate governance environment. On the public sector side, the regulatory environment is evolving, as many countries have started to enforce good corporate governance measures. In addition to the public sector initiatives, other non-profit entities were established to improve corporate governance in the MENA.

Based upon the interviews, empirical research, extensive discussions with our project contributor (GrowthGate Capital) and other evidence gathering during the preparation of this white paper few findings seem to be pushing for an improved governance landscape in MENA:

- Increased pace of governance reforms at PE-backed private companies under the augmented influence of PE firms who actively profess the value-enhancing features of better governance and include its gradual implementation as part of monitoring and exit planning processes.

- Hard lessons learned from governance failures in emerging markets including their own (Damas), and a more daring media and social networking scene that monitors with vehemence corporate laxities and opacity leading to minority right abuses.
- Improved awareness for accountability and transparency from Boards and executives by shareholders & stakeholders (employees, communities) supported by a wave of political reforms in MENA and a wind of change that do not seem to be abating soon.
- The realization that access to the global economy by regional companies either via an IPO or a strategic sale to multinationals will require them to be at par with best standards of governance (independence, disclosure & transparency); and that poor governance is cause for price depression and opportunity loss.

VI. Conclusion

While improvements in corporate governance have occurred in the MENA region (through regulations, private sector initiatives, etc.) there is still an incomplete understanding of the role of corporate governance and its benefits. However, initiatives from public, private and non-profit entities that demonstrate the positive impact of good governance in the region are enabling positive change. Indeed, corporate governance is becoming more relevant to the different players in the market and moving forward, we have a positive perspective as culture around corporate governance evolves as entities come to appreciate the benefits of good governance. PE firms are, for the most, focused on including good governance in their investment cycle and despite the several challenges they face they are pushing for better implementation of corporate governance.

Glossary of key terms and abbreviations

Term	Definition
Board or BoD	Board of Directors
CEO	Chief Executive Officer
CFO	Chief Financial Officer
Codes Corporate	
Governance Codes	Codes
GCC	Gulf Cooperation Council
IFC	International Finance Corporation
IRRC	Institutional Investors Research Center
MENA	Middle East and North Africa
NED	Non-Executive Director
OECD	Organization for Economic Cooperation and Development
PEGCC	Private Equity Growth Capital Council
SEC	Securities and Exchange Commission
UK	United Kingdom

Exhibits

Exhibit A: List of IRRC provisions as defined in the Corporate Governance and Equity Price paper[41]

Antigreenmail	Greenmail refers to a transaction between a large shareholder and a company in which the shareholder agrees to sell his stock back to the company, usually at a premium, in exchange for the promise not to seek control of the company for a specified period of time. Antigreenmail provisions prevent such arrangements unless the same repurchase offer is made to all shareholders or approved by a shareholder vote. Such provisions are thought to discourage accumulation of large blocks of stock because one source of exit for the stake disclosed, but the net effect on shareholder wealth is unclear [Shleifer and Vishny 1986, Eckbo1990].
Blank Check	Preferred stock is stock over which the Board of directors has broad authority to determine voting, dividend, conversion, and other rights. While it can be used to enable a company to meet changing financial needs, its most important use is to implement poison pills or to prevent takeover by placing this stock with friendly investors.
Business Combination laws	Laws that impose a moratorium on certain kinds of transactions (e.g., asset sales, mergers) between a large shareholder and the firm, unless the transaction is approved by the Board of Directors. Depending on the State, this moratorium ranges between two and five years after the shareholder's stake passes a pre-specified (minority) threshold.
Bylaw and **Charter** amendment limitations	Limit shareholders' ability to amend the governing documents of the corporation. This might take the form of a supermajority vote requirement for charter or bylaw amendments, total elimination of the ability of shareholders to amend the bylaws, or the ability of directors (beyond the provisions of state law) to amend the bylaws without shareholder approval.
Cash-out laws	Enable shareholders to sell their stakes to a "controlling" shareholder at a price based on the highest price of recently acquired shares.

[41] Corporate Governance and Equity Prices - [Quarterly Journal of Economics 118(1), February 2003, 107-155]

Classified Board (or "staggered" Board)	One in which the directors are placed into different classes and serve overlapping terms. Since only part of the Board can be replaced each year, an outsider who gains control of a corporation may have to wait a few years before being able to gain control of the Board.
Compensation Plans	With changes-in-control provisions allow participants in incentive bonus plans to cash out options or accelerate the payout of bonuses should there be a change in control. The details may be a written part of the compensation agreement, or discretion may be given to the compensation committee.
Director indemnification **Contracts**	Contracts between the company and particular officers and directors indemnifying them from certain legal expenses and judgments resulting from lawsuits pertaining to their conduct.
Cumulative Voting	Allows a shareholder to allocate his total votes in any manner desired, where the total number of votes is the product of the number of shares owned and the number of directors to be elected. By allowing them to concentrate their votes, this practice helps minority shareholders to elect directors.
Directors' Duties	Allow directors to consider constituencies other than shareholders when considering a merger. These constituencies may include, for example, employees, host communities, or suppliers. This provides Boards of directors with a legal basis for rejecting a takeover that would have been beneficial to shareholders.
Directors' Duties laws	Allow similar expansions of constituencies.
Fair-Price	Limit the range of prices a bidder can pay in two-tier offers. They typically require a bidder to pay to all shareholders the highest price paid to any during a specified period of time before the commencement of a tender offer, and do not apply if the deal is approved by the Board of directors or a supermajority of the target's shareholders. The goal of this provision is to prevent pressure on the target's shareholders to tender their shares in the front end of a two-tiered tender offer, and they have the result of making such an acquisition more expensive.

Golden Parachutes	Severance agreements that provide cash and non-cash compensation to senior executives upon an event such as termination, demotion, or resignation following a change in control. They do not require shareholder approval. While such payments would appear to deter takeovers by increasing their costs, one could argue that these parachutes also ease the passage of mergers through contractual compensation to the managers of the target company [Lambert and Larcker 1985].
Director **Indemnification**	Uses the bylaws, charter, or both to indemnify officers and directors from certain legal expenses and judgments resulting from lawsuits pertaining to their conduct.
Limitations on director **Liability**	Charter amendments that limit directors' personal liability to the extent allowed by state law. They often eliminate personal liability for breaches of the duty of care, but not for breaches of the duty of loyalty or for acts of intentional misconduct or knowing violation of the law.
Pension Parachutes	Prevent an acquirer from using surplus cash in the pension fund of the target to finance an acquisition. Surplus firms are required to remain the property of the pension fund and to be used for plan participants' benefits.
Poison Pills	Provide their holders with special rights in the case of a triggering event such as a hostile takeover bid. If a deal is approved by the Board of directors, the poison pill can be revoked, but if the deal is not approved and the bidder proceeds, the pill is triggered. Typical poison pills give the holders of the target's stock other than the bidder the right to purchase stock in the target or the bidder's company at a steep discount, making the target unattractive or diluting the acquirer's voting power.
Secret Ballot (also called confidential voting)	Either an independent third party or employees sworn to secrecy are used to count proxy votes, and the management usually agrees not to look at individual proxy cards. This can help eliminate potential conflicts of interest for fiduciaries voting shares on behalf of others, and can reduce pressure by management on shareholder-employees or shareholder-partners.
Executive **Severance** agreements	Assure high-level executives of their positions or some compensation and are not contingent upon a change in control (unlike Golden or Silver parachutes).

Silver Parachutes	Similar to Golden Parachutes in that they provide severance payments upon a change in corporate control, but differ in that a large number of a firm's employees are eligible for these benefits.
Special Meeting	Limitations either increase the level of shareholder support required to call a special meeting beyond that specified by state law or eliminate the ability to call one entirely. Such provisions add extra time to proxy fights, since bidders must wait until the regularly scheduled annual meeting to replace Board members or dismantle takeover defenses.
Supermajority	Requirements for approval of mergers are charter provisions that establish voting requirements for mergers or other business combinations that are higher than the threshold requirements of state law.
Unequal Voting	Limit the voting rights of some shareholders and expand those of others. Under time-phased voting, shareholders who have held the stock for a given period of time are given more votes per share than recent purchasers. Another variety is the substantial shareholder provision, which limits the voting power of shareholders who have exceeded a certain threshold of ownership.
Written Consent	Can take the form of the establishment ofmajority thresholds beyond the level of state law, the requirement of unanimous consent, or the elimination of the right to take action by written consent. Such requirements add extra time to many proxy fights, since bidders must wait until the regularly scheduled annual meeting to replace Board members or dismantle takeover defenses.

Exhibit B: List of Reported Corporate Governance Metrics Implemented by MENA PE firms post Investment

Independent Board members more than 1/3 of Board.
Non-executive Board members around ½ of the Board.
Separation of CEO and Chairman roles.
Succession planning mechanism for CEO and other key executives.
Defined processes for Board decision-making.
Rules for representation of significant shareholders.
Active audit committee.
Active nomination and remuneration committee.
Regular (at least four) Board meetings per year.
Regular shareholder assembly meetings.
Measures protecting minority shareholders rights and access to information.
Corporate governance code compliant with applicable regulations.
Remuneration and incentive (performance based) scheme for executives.
Remuneration policy approved by shareholders.
Rules and disclosures practices addressing related party transactions.
Rules and disclosures practices addressing conflict of interest.
Big 4 or locally reputable audit firm as statutory auditors.
Effective internal audit function.
Internal controls and procedures addressing accounting/financial/reporting matters.
Internal controls and procedures addressing operating matters.
Internal controls and procedures addressing risk management and compliance.
Quarterly/monthly reporting of results and key performance indicators to the Board of directors.
Code of ethics including anti-bribery and fraud issues.

Source: Interviews with MENA PE firms, April 2013