International Corporate Governance Network
10th Annual Conference – Rio de Janeiro

ALTERNATIVE PATHS TO CORPORATE GOVERNANCE; VENTURE AND HEDGE FUNDS

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Good morning everyone,

I am honored to be asked to speak on this broad topic, and I will begin with the end. In short my conclusion is this: In the case of Brazil, there is no Alternative Path, other than best practices to corporate governance. In countries such as ours, where capital markets are not highly developed, where investment culture is still weak and where entrepreneurial risk does not receive its due reward, overshooting in Best Practices in corporate governance will help across the line from seed capital to public markets – and that clearly includes alternative assets, the focus of my short speech today.

For a long time I have argued that being a successful investor in Brazil's public markets requires strong value-creating governance activism. In my opinion, the discipline presented by successful General Partners (GPs) of alternative assets and their involvement with entrepreneurs, scientists, managers and Limited Partners (LPs) have a parallel with value-creating corporate governance activism.

PE/VC equity stakes typically have very strong agreements with management and/or entrepreneurs. They sit on their boards and at least participate in key decisions such as capital budgeting and hiring and firing. Their presence represents a constant pressure for results and certain PE/VC firms give credibility to the company they invest in, thus helping to open doors.

Of course, the process of private companies being funded by VCs/PEs frequently comes with labor pains. Entrepreneurs are usually self-made men, accustomed to taking decisions on their own. But investors are looking for someone who understands that dividing today can mean multiplying tomorrow. Sharing power with investors inevitably reduces the entrepreneur's slice of the cake. But it can help the cake to grow, to the benefit of all involved.

VC/PE funded companies move faster in the learning curve of dealing with investors. They have a sounding board, at General Partner level, scrutinizing, criticizing and reviewing their strategic and financial planning, investment discipline, identifying opportunities for alliances, merger and acquisitions. It means that all of these activities are carried out on a more transparent basis and if these companies are private, they benefit substantially when they go public -- they are used to these practices and understand their value.

Why do VC/PE place so much emphasis on cash flow? Why are the public markets so concerned with good accounting and auditing standards? Before investing, there is the need in due diligence contracts to align the interests of shareholders with those of VC/PE investors. Why in public companies should compensation committees be run by independent board members? The same for audit committees. The PE/VC investor is in a way similar to the independent board member to public investors, as he is independent of the entrepreneur and looking after the interest of the limited partners of his funds.

What else is good corporate governance in practice? It adds credibility and transparency to the firms that practice it. To start right with transparency only adds to credibility, now and in the future at the time to cash out. Specifically in the case of Brazil where the IPO route to “cash out” is so narrow. This year, after a five year drought, we have seen three IPOs in Brazil – and a significant factor in this resurgence is the adoption of more stringent listing requirements.

Brazilian Capital Markets

Brazilian capital markets present some characteristics that *per si* demand corporate governance activism. We will discuss three of them: existence of non-voting shares, concentration of voting shares in a few hands and duty of loyalty of the management.

The liquidity of the Brazilian capital market is concentrated in non-voting shares. Several issues can be raised around this topic. For example, there is an increasing perception that during changes of control, shareholders that own non-voting shares are not as fairly compensated as owners of voting shares.

Curiously this process in Brazil was accelerated during the privatization period as the new owners, having paid perhaps too much for control, averaged out by paying low prices for non voting shares during delistings. Brazil issued new public share offers´ rules (“OPA”) to mitigate the delisting problem.

Recently the concerns around this issue came back into the spotlight, with the announcement of a merger. If the market does not price this and other potential risks associated with non-voting shares one can not ask the regulator to enforce what is not in the law.

The same rationale goes for companies that deserve a corporate governance premium, such as those which have extended tag-along for non voting shares and other rights non existent in the law, e.g. board representation. In short, the markets also have to play their part. All things being equal, investors must be willing to pay more for companies which maintain good corporate governance practices.

According to the Brazilian legal frameworks directors owe a duty of loyalty and a duty of care to the company, and not to the shareholders that voted for his or her appointment.

However, largely because the ON shares holdings are extremely concentrated in a few hands, we can say that, in general, directors follow controlling group guidelines.

But why will overshooting in corporate governance help alternative assets in Brazil to prosper, rather than create an annoying cost?

In order to make sure we do not think corporate governance is a panacea, I want to reinforce at least three obvious steps that are indispensable for a successful investment: the quality of the management, the price you pay and the business itself, with its prospects for growth and future profitability.

Investment discipline is required in all investment stages: due-diligence, valuation, monitoring and harvesting. Extensive due diligence on the business and particularly on the entrepreneurs/ owners/management/ is a key successful factor. GPs need to make a lot of visits and calls, and really do their homework before they make an investment.

There are several important differences when discussing and comparing alternative assets in Brazil to the US and even to Europe. I want to highlight three of them.

#1- Size and Focus

In a nutshell we can define that in the US venture capital tends to go hand in hand with technology, and private equity funds, including hedge funds, are large in both numbers and values. In Europe a lot of capital (when compared to Brazil) is used to finance changes in firms ownerships, typically in buy outs, and only recently are larger amounts being moved to technology.

In Brazil alternative assets represent a very small percentage of Brazilian investors´ portfolio. According to ABCR (Associação Brasileira de Capital de Risco), after peaking in 2000 at US$1.4 billion, the total amount reported by companies receiving investments from VC to PE funds was US$342 mm in 2002 and US$451 mm in 2003. Even the total amount invested as private equity adds up to less than one or two funds raised in the US or even Europe. Typically investments are in non-technology companies. With the exception of a short lived dot.com bubble, the typical transactions were consolidation (drugstores, supermarkets, billboards), fast growing consumer firms or, in the recent past, privatization (telcos, electricity and railroads).

#2- Cultural

There are important cultural differences that reflect on investors and entrepreneurs´ behavior, but the fundamental cultural difference is in the way the risk-reward principle is dealt with and applied. Very seldom does our media encourage entrepreneurial behavior by giving coverage to good examples of successful role models. Perhaps partially due to our heritage, success is not viewed in the same manner as in the US. Additionally, public opinion places professional restrictions on individuals involved in so called “innocent bankrupts" i.e. when bankruptcy is the result of bad business decisions and not criminal activity.

#3- Legal

On the legal front, the Brazilian Bankruptcy Law is under review and should facilitate restructurings. The existing law makes restructuring virtually impossible because among other problems, liabilities are transferred to new owners. Last but not least, academic research has shown that Civil Law seems to be a handicap for developing capital markets, and good corporate governance rules are useless if not implemented or not used, just as good laws are ineffective if there is no enforcement.

The risk aversion culture, therefore, is perfectly rational. It is interesting to notice that on an Article at the Financial Times, dated March 7, 2004 by Wolfgang Munchau, has argued that much the same is true in Europe. Brazilian entrepreneurs, like their European counterparts, face higher risks and lower rewards than those in the US. It is no surprise that the majority of Brazilian PHDs can be found in Universities while in countries like the US or Korea they are putting their knowledge to practical use in companies.

But where does good corporate governance fit in with VCs/PEs, i.e. alternative assets in general?

The link is shareholder activism. Shareholder activism plays a positive role in good corporate governance. In a similar way, successful General Partners applying their usual discipline add value to the companies in which they invest.

In summary, we are dealing with a country where capital markets are not highly developed, where investment culture is still weak and where entrepreneurial risk does not receive its due reward. It is a very different reality from that of the world's most developed markets. But this does not mean, by any stretch of the imagination, that we need less corporate governance requirements than in the developed world. It is precisely because of our current deficiencies that we need more transparency, more credibility, more accountability.

It is for this reason that in terms of corporate governance requirements in Brazil, including investments in alternative assets, I am in favor of an overshoot, with the right dose of common sense. Failure to move in this direction would be to shoot our own markets in the foot.

Experience in Brazil on ValueCreating governance activism seems to support this case.

Thank you.