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12th Instituto Brasileiro de Governança Corporativa (IBGC) Annual Conference

Session: "Family Controlled Companies around the world" on October 25th (8:30am-9:45am).

Talking points for Mr. Paolo M. Martelli, Director Latin America and the Caribbean - IFC

Sources: IFC Corporate Governance Integrated Communications Strategy. / Presentations by Mike Lubrano, Darrin Hartzler and Phil Armstrong. / Publications: IFC Family Business Governance Handbook, Companies Circle Practical Guide to Corporate Governance and IFC Corporate Governance Directives and Methodology. / Webpages: IFC in Latin America, IFC CG Unit and Global Corporate Governance Forum.

Introductory Comments

- Good afternoon. I think we each have about 10 minutes to cover a diverse set of issues.

- In the interests of time, I will attempt to highlight some key points for consideration and hopefully to generate some useful conversations that we can continue during the Q&A time.

- With this in mind, I will share **some practical perspectives** from our experiences working with Family Controlled Companies around the world and with specific reference to Latin America where as a Regional Director I observe how IFC is at the forefront of private sector initiatives aimed at making markets work for businesses and individuals.

- In FY11, IFC invested nearly $19 billion globally in over 500 projects in 102 countries, of which $12.2 billion was for our own account. Additionally, we mobilized nearly $6.5 billion from other investors. In the Latin American & Caribbean region we totaled commitments for about $3 billion and mobilized an additional $2.2 billion from other investors.

- For the IFC, Family Controlled Companies are a key element for growth. They are the leading form of business organization in Latin American countries, even among large listed companies, which means that they have the potential to be –and some already are- the leading companies of the future – if supported with the right tools. IFC tries to provide those tools that will allow companies to go beyond compliance.

- Today one of the biggest challenges most companies confront is that there is a vast list of codes, standards and other instruments governing everything from auditing practices to corruption. Hence Family Companies need to be clever in understanding that:

- governance is a journey, not a destination. It is important to remember that what works at one stage of the company's ownership cycle, such as the Founder(s) Stage; the Sibling Partnership Stage or the Cousin Confederation Stage usually does not work well in other stages. So controlling families should take a careful look at the governance solutions recommended for their particular stage of development and develop over time;
- a company's governance should be tailored to its own reality and needs – and those of its investors. Each case is difficult to understand because it is unique, but what is not unique are the ways to find solutions to those realities and needs;
- the family does not only need a leader but also a political will from most of the members to achieve a tangible impact;
- communicating good governance to the Markets is a challenge that requires transparency and a good reputation; and
- corporate governance measures at the family and business levels provide good solutions to family ownership challenges and often are indispensable to the long-term success of the family business—and peace in the controlling family, especially with succeeding generations.

- We see dealing with Family Controlled Companies as a three-way joint venture in which the board represents the shareholders from the local company and we provide IFC's and global technical partners. In this scenario, Corporate Governance is key...

So…Why IFC cares about Corporate Governance

- For the IFC, **Corporate Governance** refers to the **structures** and **processes** for the direction and control of companies. We see Corporate Governance, then as an important **Portfolio Risk Management tool** and, like any other investor; we care about understanding the companies' governance policies and associated risks, mainly in family companies where their governance becomes a major investment risk. Good Family owned business governance is a very important mechanism to provide sustainability in the long-term by aligning the interest of the family with focus in preserving wealth. The family must understand that all aspects of good governance, -even the trivial ones like those of some related parties transactions cases- make a huge difference for the investor by leaving out major risks. In the worst corporate governance environments, poor standards and weak enforcement continue to be barriers to investment even for the IFC with its mandate to work in frontier markets. Improving the corporate governance of investee companies allows the IFC to work in higher risk environments. It should also bring an increase in the market valuation of companies and attract more investors, which together increase the opportunities for IFC to exit its equity investments on favorable terms.

- Corporate Governance has also demonstrated that it **adds value to clients**. Numerous academic and empirical studies have shown that good governance brings many improvements contributing to better overall performance of companies , strengthens its performance during crisis times and forges the environment that allows company value creation. A recent publication by the **Latin American Companies Circle** sponsored by IFC, the Global Corporate Governance Forum and the OECD shows that Circle member-firms, which have invested more in corporate governance policies and practices, have produced substantially better operational and market results than their non-member Latin American peers. Let me point out that the Companies Circle has or has had some Family Companies within their members such as Ultrapar, Marcopolo, Homex, Suzano, Buenaventura, Ferreyros , Algar, Los Grobo and **Carvajal** -who is today joining us at this same session-.

- Furthermore, if IFC does not work to improve the corporate governance of client companies, then it takes on not only investment risk, but also a **reputational risk** for involvement with companies with poor governance or, in the worst cases, corporate scandals. This reputational risk is particularly serious where stakeholders and equity investors stand to lose from governance abuses.

- We also find it an interesting area because of its **complexity and difficulty in reaching out and educating the family members.** From our global experience we have learned that a way to mitigate these complications is by enabling and stimulating the discussion among peers: families talking to families. In these cases, the IFC facilitates dialogue that allows family owned companies to fully appreciate the meaning of good corporate governance, avoid moments of tension and resolve complex situations among its members. Such eye-opening revelations to the families are very important for investors since they represent the difference between being sustainable and not sustainable.

So, What has our experience told us?

- As Graham and Dodd said over 80 years ago: "*Ownership is a continuing process. Certainly there is just as much reason* ***to exercise care and judgment in being a shareholder*** as *in becoming one*."

- IFC's corporate governance methodology involves a series of steps that allows the classification of companies into one of five possible paradigms -of which one is "Family Companies"- This permits using the appropriate corporate governance analyses tools and self-assessment matrix. The matrix focuses on five areas of governance (Commitment to good corporate governance, the Board of Directors, Control Environment and Processes, Transparency and Disclosure, and Shareholders Rights) rated based on four levels of achievement.

- The Specific Issues IFC analyzes for Family Control Companies are:
  - Succession Planning and its timely implementation,
  - Family Employment and the avoidance of adverse selection,
  - Family Salary-Earners vs. Dividend Receivers,
  - Incentivizing Non-Family Managers,
  - Treatment of Outside Financial Stakeholders,

- Formalities and how they do matter, how to avoid role confusion and have a good board in practice,
- Family's Long-Term Role as Shareholder: as the Company passes to succeeding generations, how should they do their voting, and
- The **Family Constitution**; in my opinion, the most important tool that a Family Owned Business could have for good corporate governance implementation. A company that does not have the stomach to go through the exercise of developing such constitution still cannot have strong and trustable corporate practices elsewhere. The process of establishing a Family Constitution will allow them to realize what their situation, good practices and shortcomings are. It will create the parameters for an ongoing work agenda on corporate governance but at the same time take out all the drama that usually this subject involves.

- It is important to note that family control should not be seen as a liability for investors:
  - they have a long-term view in decision-making (consistent with investors);
  - they embrace the possibility of using unconventional strategies, enabling them to respond rapidly to changing market circumstances and giving the flexibility to take advantage of opportunities and address emerging risks;
  - they often have the desire to build a business for future generations and thus be sustainable;
  - and hold a strong commitment from the family management to their company assuring continuity.

  At IFC all this is what we call "the family business edge" which usually translates into profit.

- Now, it would be unwise not to recognize that we have faced special challenges. Among these challenges we could point out:
  - the need to distinguish family relationships and company relationships (as true Separation is impossible), especially financial relationships and accounts;

- the need to overcome the informality of governance policies as "common" understandings may not be so universally held or understood;
- the need to improve usually weak control environments; and
- that challenges only increase as the family grows more complex with succeeding generations.

What Comes Next [closing remarks]…

- Time unfortunately does not allow me to elaborate more on these many issues but I trust that it provides some food for thought.

- IFC has worked on the key issues of corporate governance at the grass-roots level for decades - structuring client companies, appraising investment opportunities, and nominating Board members. This practical experience allows IFC to be at the forefront of Corporate Governance development. An example of this is the Global Corporate Governance Forum's work as the leading knowledge and capacity building platform dedicated to corporate governance reform in emerging markets and developing countries. Or the recent adoption of the Corporate Governance Development Framework, where IFC and other 28 Development Financial Institutions are standardizing the tools for better corporate governance –inspired mainly on IFC's methodology, including those tools for Family Companies-.

- **We believe that corporate governance in Family Controlled Companies should not be understood as a cost but as investment for growth, innovation, sustainability and above all corporate responsibility to society. As the IFC-Global Corporate Governance Forum's slogan says: good corporate governance creates <u>better companies</u> with significant benefits for <u>better societies</u>. This is the true bottom line.**

- Thank you for your attention and I look forward to continue the conversation at the Q&A session.