THE ACG REPORT

ACG Company Watch | Corporate Governance | Press Review

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German steel company fails to improve governance following earlier scandals and is investigated over illegal payments to Israeli officials.

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Another institution, a 300 year-old private bank, is brought down by a combination of corruption and parent company mismanagement.

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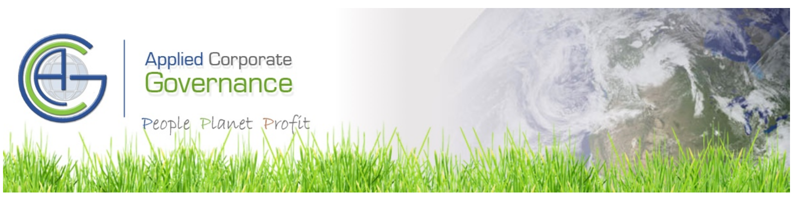
Snap

Gambling on shares in a social media giant with an IPO valuation belying huge losses, opaque governance and management profiteering.

Introduction

Good corporate governance should be about keeping the company on the rails, so to speak. Attention to the five principles underpinning ACG's holistic approach to governance will ensure that companies don't go off the rails. Not paying sufficient attention to one or more of these principles, or deliberately flouting them, will sooner or later take the company off the rails.

This month from the wide choice available, we select some examples where the boards have not been careful enough about their company's reputation or have been deliberately uncaring about it, and one where the reputations of two potential merger partners were so different that the initiating board must have been tone-deaf (if you'll forgive the metaphor).



Golden Rules

The Key to Good Corporate Governance

Staying on the rails

Our five principles of good corporate governance are designed to ensure organisations stay on track:

- **Ethical culture**, ensuring that everyone has the common good and long-term health of the organisation in mind
- **Clear, congruent goals**, which focus action around a positive outcome for all stakeholders
- **Sound strategy**, our map of the terrain which shows the best known way of achieving the goals
- **Organisation**, the engine designed to move us towards our goals
- **Transparency** and openness, ensuring if mistakes happen they are detected, admitted and acted upon.

Applied corporate governance is about regularly checking, modifying and monitoring adherence to these principles in a sincere and open way - one which allows for an "alarm cord" to be pulled before accidents happen.

If you need help to keep your organisation on the rails through training and/or implementation, contact us at info@applied-corporate-governance.com

In the headlines this month

Thyssen Krupp

We kick off with a company whose corporate governance woes we discussed some time ago in early 2013. Thyssen Krupp had been fined by the German Federal Cartel Office for involvement in a conspiracy to supply rails at inflated prices to Deutsche Bahn. And there had been an earlier scandal involving board members and expenses. Chairman Dr Gerhard Cromme, who later resigned, brought in a new CEO, Dr Heinrich Hiesinger, to get a grip on strategy (Thyssen Krupp had got into a disastrous steel venture in the USA) and presumably to get a grip too on the ethical side.

However, earlier this year, the German newspaper, Handelsblatt, reported that it had evidence that Thyssen Krupp had made illegal payments to senior Israeli military and government officials in relation to the supply of submarines. The sacked former Defence Minister said he had opposed the unnecessary purchase of three additional submarines. After his dismissal the procurement process went ahead, but the initial competitive tender was abandoned, apparently at the insistence of the Prime Minister, Benjamin Netanyahu, and Thyssen Krupp was awarded the contract. It later transpired that the agent for Thyssen Krupp in Israel employed as its lawyer David Shimron, who happens to be Mr Netanyahu's cousin and also acts as Mr Netanyahu's personal lawyer. Apparently the deal took less than a year to conclude, which local media considered a surprisingly short time by comparison with comparable deals.

Regardless of the rights and wrongs, which no doubt the Israeli authorities will ultimately determine, what was the German steel company doing putting itself in this position? Its earlier record should surely have made the executive and supervisory boards look particularly carefully into defence deals, which are notoriously prone to questionable payments.

Bosche

Still in Germany, we look at Bosche, one of the world's biggest suppliers of electrical parts to the auto industry, and one which has developed and guarded a reputation for conservatism and probity in the 130 years of its existence. Its war-time chief executive was later commended by Israel for helping Jews to escape from concentration camps, and it has been regarded as one of the most credit worthy companies in Germany.

Unfortunately, in its role as a major supplier to Volkswagen (see our first issue), it was asked to write complex software for engine management devices in VW's diesel powered cars. VW had developed a new fuel injection system to help manage emissions and needed the specialist software capabilities of Bosche to make it work as they planned. Apparently, according to papers shown to the US courts, the supplier had reservations about the possible misuse of this software, though Bosche says this is a misunderstanding about the nature of the discussions. However, the software was actually used to enable the notorious "defeat devices" which allowed VW's latest diesel cars to pass emission tests in the USA, while massively exceeding prescribed limits under road conditions (see our article in October 2015). When the scandal broke, the role of Bosche's software in the illegal devices was exposed, and made worse by their apparent subsequent collaboration in refining this software. And the company became enmeshed in the legal challenges that were enveloping VW.

In early February, Bosche agreed a settlement with US owners of affected vehicles, without admitting wrongdoing, for a sum of $327.5m. Its CEO said they were settling in order to be able to move forward and concentrate on the transformation process that the company was embarking on relating to a massive move into software related activities. But there is still an on-going investigation by the German prosecutors.

How sad that a company which prides itself on its corporate reputation should find its good name dragged through the mud like this. An awful warning about the need to take extra care when a key customer asks you to do something which may ring warning bells. The short term benefit of keeping the customer happy, or indeed keeping the customer at all, has to be weighed against the damage if the worst fears are realised. As Warren Buffett, and many others, have said, it takes a lifetime to build a reputation and no time at all to lose it.

Coutts and IMBD

At the beginning of February, it was reported that Coutts, a private bank and wealth manager, one of the oldest in the world, had been fined SF6.5m for money laundering offences in relation to the Malaysian fund IMBD.

This is a confluence of scandals, as Coutts has been owned since 2000 by RBS when it acquired Coutts' then owner, NatWest Bank, and as the world knows, RBS went spectacularly bust after the 2008 financial crash and had to be rescued by the UK government. Since then it has been paying one huge fine after another for its irregular and illegal actions before and immediately after its collapse. The parallel scandal derives from the relationship between IMBD and a client of Coutts, a young Malaysian businessman, who apparently opened an account in 2009 on the understanding that $10m of family money would be paid in. In practice, around $700m was deposited from IMBD, the Malaysian fund set up by the Malaysian Prime Minister. IMBD subsequently attracted global interest for all the wrong reasons, and is worth an article in its own right. Suffice it to say here that it has been alleged that more than $3.5bn has been diverted from the investment fund and not only Swiss prosecutors but Singaporean and American authorities have been pursuing this.

Two other Swiss banks were punished for their involvement with IMBD and Goldman Sachs was investigated, subsequently suffering the resignation of its former top man in South East Asia. Officials in Abu Dhabi and Saudi Arabia were also drawn into the investigations by the Swiss authorities and the whole affair has become highly politicised with the Malaysian Prime Minister denying any wrongdoing in relation to IMBD.

But the end result of RBS's failings and the involvement of Coutts with the IMBD scandal is the dismantling of Coutts, with its assets being sold to a Swiss bank and the rump of the bank being wound down by RBS. That's what happens when banking professionalism and integrity take second place to an obsessional search for highly profitable business. What a sad end to a 300 year old, formerly highly respected institution.

KraftHeinz/Unilever

Back in 2009, US food company Kraft acquired venerable UK food company Cadbury in a controversial takeover, during which it promised to keep open a UK factory. Within a short while after gaining ownership of Cadbury, Kraft closed the factory anyway.

Fast forward eight years and Kraft's successor, Kraft Heinz, a rather different company but crucially bearing the same name, made a bid for another venerable company, the much larger, joint UK/Dutch food company, Unilever. If the earlier Kraft was seen as aggressive, it pales by comparison with the Kraft of today which was formed out of the merger with (acquisition by) Heinz, a company controlled by 3G Capital and Berkshire Hathaway. 3G has a deserved reputation for building size and profitability by acquiring underperforming targets and ruthlessly cutting costs. Unilever has in recent years focused on building brands and environmental sustainability and makes a virtue out of sacrificing short term profits for longevity. In its early days, Lever Bros and its founder built a reputation for looking after its employees through such actions as investment in housing for its staff and local good works. Indeed, its initial soap product was launched with the aim of improving public hygiene.

So 3G Capital's business model is to acquire and cut, while Unilever's is to invest and nurture. For 3G Capital, the logic was very clear. It would gain access to Unilever's extensive presence in emerging markets and cut significant, unnecessary (in its view) costs to improve revenue and profitability significantly. For Unilever, there was no corresponding logic at all. How could these two very different cultures survive a merger? The short answer is that they probably couldn't. Unilever spotted the intention behind the initial approaches and rapidly organised its rejection. It communicated with Warren Buffett, who famously doesn't do contested takeovers, and encouraged the politicians in the UK and Holland to make noises about investigating the mooted takeover (remember Cadbury), and killed the approach within days.

But for us, the lesson is that the investment banks, hungry for the huge fees that would have accrued, encouraged the 3G approach, with what appears to have been a complete disregard for the radically different cultures of the two huge businesses. If the Unilever shareholders had been persuaded by the prospect of a quick profit from the sale, the finance people at Unilever quickly calculated that 3G probably planned to spin off part of the combined company at a valuation equivalent to the value of the takeover. So they would have got Unilever for nothing. That was an easy one to answer, as they could then put forward their own spin-off as a possible future strategy, leaving the residual company with a significant value, which 3G would otherwise have acquired for nothing.

So 3G withdrew promptly, and Unilever kept its independence. But what does that say about the approach to corporate governance of a company like 3G? Focus on the long-term future of the business and the employees, invest to develop brands and new products, concern itself about environmental sustainability? I think not.

Snap

Snap is a company whose losses of $515m in 2016 exceeded its revenues of $404m, but whose valuation on the first day of trading at its recent IPO was $24bn. The shares that were so highly valued had no voting rights. What does that say about holistic corporate governance, by which we imply taking account of the interests of all the key stakeholders?

One argument says that anyone who is prepared to invest their money on that basis does so with their eyes wide open, and it's clearly just a bet on the shares increasing in value – casino investment, if you like. Another argument says that index linked funds are obliged to invest in companies like this if they are large enough, and being obliged to invest in a company in which they have no voting rights is wrong. A purist argument says that it's wrong on principle to take money from investors while refusing them any say in the company's policies or management, so that their only recourse is to sell their stake. A counter argument is that of the supporters of the block shareholding who say that institutional and activist investors are essentially short term in their objectives and the long term future of the company is better assured by restricting their influence.

John Plender, writing in the FT, quotes a 19th century German banker:

"shareholders are stupid and impertinent – stupid because they give their money to somebody else without any effective control over what this person is doing with it, and impertinent because they ask for a dividend as a rewards for their stupidity"

Snap's approach to the market would appear to embody this view pretty well. So, without describing this as a scam, as certain commentators have done, or "junk equity" like Anne Simpson, investment director at CalPERS, we would have to deplore the principle it espouses. If Snap adopted our holistic approach to corporate governance, including regular stakeholder surveys to keep the company in tune with their objectives and transparency over the results of these surveys, we would be more reassured. But this seems most unlikely, as a belief in these principles would have precluded the issue of non-voting shares in the first place.

Added to the governance issues, the immediate selling off of tens of millions of shares by top management hardly gives cause for confidence.

So, in our view, these shares are for gamblers alone and we wouldn't expect Snap to top the league table of well-governed companies any time soon.

The last word...

Last month we said that we would highlight examples of company managements showing poor judgement. The five companies cited above surely indicate board decisions (or board-approved management decisions) which were badly judged and, if not taking all the companies off the rails, have certainly damaged their brands.

A final thought. In addition to monitoring companies which wobble on the rails, we should, perhaps, start to track the individuals who bring about these flawed decisions and threaten the future of the companies they manage.

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We hope you have found this ACG Report useful. We will be building up the range and types of content included in the report over the coming months (for example regional updates from our correspondents around the world), so would like to hear from you to find out what you would most like to see included.

If you would like to participate in our reader survey, please click on the link below - it should take you less than 2 minutes to complete:

https://survey.zohopublic.com/zs/y8B03L

As a thank you for for taking part, we would like to offer you 50% off the first year's subscription when we launch the paid version of this newsletter, following your feedback. If you are on our mailing list, we will send you details and your coupon codes by email.

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