The Guide to Global Corporate Governance Developments
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THE ACG REPORT

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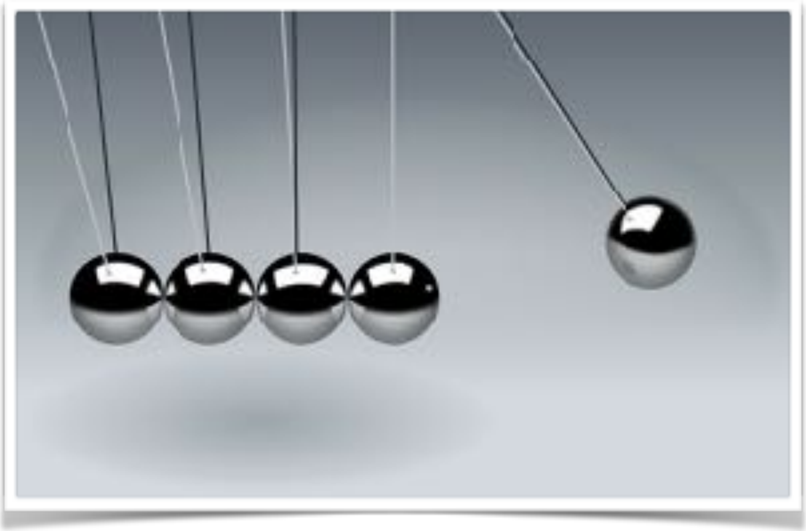
There is still a whiff of poor ethics after a series of manoeuvrings by the current president, which is doing little to improve its image.

Tracker Funds

The huge concentration of investment by passive funds, themselves controlled by a few huge groups, effectively constitutes an oligopoly and compliance with codes is massively ineffective in ensuring good governance.



Introduction

In this fifth Report, we look at a range of different situations in which good governance, or rather its absence in some way or another, has led to subsequent issues; in some cases with severe consequences for the company or individual involved.

Commodity trader, Noble, is facing potentially terminal problems, the career of a young doctor has been wrecked and the reputation of Fifa's president has been tarnished.

AkzoNobel, by consequence has had an escape, but there are governance issues arising from the growth of tracker funds.

Golden Rules

The Key to Good Corporate Governance

Governance & expansion

From Enron to Noble, aggressive expansion has come at huge cost. Our holistic five principles of good corporate governance help ensure that a balanced, long-term view guides growth:

- **Ethics**: regular monitoring of business practices through independent surveys is the best early-warning system.
- **Clear, congruent goals**: the long-term ability of the organisation to fulfil its mission should not be sidelined when striving for growth.
- **Sound strategy**: delivering the agreed goal while serving all stakeholders (not just shareholders) ensures ongoing balance and smooth operation.
- **Organisation**: continuous and holistic assessment of the company's ability to deliver growth objectives is essential.
- **Accountability-Transparency**: communicating clearly and honestly through bad as well as good times ensures trust; as does taking responsibility for decisions and consequences.

So many organisations fail through un-checked expansion. *Applied Corporate Governance* means living by these principles and setting up systems to support you. For more info, contact us at info@applied-corporate-governance.com.

In the headlines this month

Noble

Back in 2015 Iceberg Research, a research group, published allegations that this leading Singapore-based commodity trading company had been misleading investors by inflating asset values and booking profits prematurely.

Notwithstanding the company's denials, backed up by a PwC study that confirmed it met international standards of reporting, this had an immediate impact on its credit standing. Coupled with a collapse in commodity prices, it plunged the company into an increasingly desperate financial situation. For a trading business, its ability to fund its operations at good commercial rates is key to its success. So a downgrading in its credit standing creates short term problems for profitability, and longer term problems for liquidity as finance becomes progressively harder to raise.

Its CEO said in November 2015 that a downgrading to junk would be immaterial for the business. When Moody's did just that, he dismissed the judgement, which was based on Noble's leverage, poor profitability and negative cash flow, as misunderstanding the business. In January 2016, S & P also downgraded Noble, and its CEO arranged a sale of a significant part of the business to reduce borrowing.

But in the trading world, operating on very thin margins, an investment grade is very important, and Iceberg Research was questioning Noble's future. Next month Noble lost a big contract to market zinc, and then it had to announce a $1.2bn write down before declaring its first loss in 20 years. The hedge funds started gathering to bet against Noble. By now its refinancing costs had trebled compared with the previous year, and a few months later its CEO had gone, as its share price was down 90% from five years previously.

Noble was now in the difficult situation of having to sell the best parts of its business to cope with the liquidity issue, thus putting into question the survival of the business itself. Then its founder/chairman said he would stand down as a $500m rights issue was proposed. The change in management provided a breathing space, but by the end of the year it was posting losses and hoping to be helped in 2017 by increases in coal prices. In early 2017 it was seeking "strategic partners" and still making quarterly losses while the price of traded coal fell below expectations.

In May it appointed a new chairman, but forecast a delay till 2019 in a return to profitability. Meanwhile, cash was still flowing out. Towards the end of the month, after a further slide in the share price, Noble suspended trading in its shares. Meanwhile, the

CEO resigned and is now suing the founder, alleging that he broke an earlier agreement with him.

As of now, a search for new shareholders has proved unsuccessful and the banks are getting more anxious though Noble managed to get an extension on multi billion dollar facilities which were repayable in June. The business model itself is under question and Noble appears to have abandoned hopes of growing out of its problems or finding a strategic investor. The latest announcement is of a shrink to survive plan.

How did it come to this? It looks as if aggressive expansion, starting ten years ago buying physical assets and funded by leverage, put pressure on the whole business when certain commodity prices moved against it. It seems to have adopted aggressive accounting methods, involving mark to market, which led to imprudently optimistic asset valuations to which the founder of Iceberg Research (an ex-Noble employee) drew attention. The give-away, as with Enron and similar examples of optimistic use of mark to market accounting, was the discrepancy between declared profits and cash flow. Now, one of the leading commodity trading businesses is facing a desperate fight for survival after thirty years.

Find out more about the issues outlined here in our detailed Enron Case Study, available on the ACG website.

Whistleblowers

In our last report, we noted that Barclays Bank had ditched an externally provided whistleblowing service and that subsequently its chief executive was heavily criticised for trying to find out the name of a whistleblower employee. It still looks dangerous to be a whistleblower, despite the growing legal protection. This month, we saw two more examples of the career-threatening consequences of whistleblowing.

The automotive industry has been hit by emissions scandals, notably Volkswagen, whose travails we have documented earlier. Now we hear about Korean manufacturer, Hyundai Motor, where Mr Gwango-ho Kim, a long-serving engineer, was fired near the end of last year for allegedly leaking trade secrets. Mr Kim became concerned about safety lapses and even an engine fault, and was so worried that he reported these to the regulator, providing substantial supporting documentation.

Mr Kim was re-instated after a government ruling protecting whistleblowers, but, as big employers do, Hyundai Motors continued to hound Mr Kim, filing a criminal complaint against him. Hyundai and Kia then recalled 1.5 million vehicles in April and were ordered in May to recall nearly a further quarter million. Mr Kim resigned, and the complaint was dropped.

In Japan, Mitsubishi was embroiled in a scandal over fictitious fuel economy data, which resulted in Nissan making a big financial injection and acquiring a 34% stake. Nissan's management has introduced a whistleblowing policy and told employees to report failures rather than hide them. It will be interesting to see whether they fare better than Mr Kim.

In the UK, a junior doctor became so concerned about inadequate staffing levels in the London hospital where he worked that he reported his concerns to the duty manager. The result was that his training contract was terminated and his future career as a consultant was effectively finished. He challenged the Government agency involved and raised £140K crowd funding to pay for his legal costs. After a year he won his case at the Court of Appeal, but effectively it will have been a pyrrhic victory if his career has been permanently damaged. So whistleblowing does seem career threatening at the NHS.

AkzoNobel

In March of this year, an American paints company, PPG Industries, a leading American player in the paints and coatings industry, approached AngloDutch chemicals company AkzoNobel with a takeover proposition. It was driven by growing consolidation in the industry and probably facing an "eat or be eaten" situation. Its justification was the complementarity of the businesses whereby the amalgamation would lead to a world-leading company with the bottom line enhanced by a single infrastructure supporting a broader product offering.

The approach ran into a vigorous opposition from the management of AkzoNobel, who said they could raise earnings from their in-house plans, coupled with vociferous political opposition to the takeover of a "national champion" in the run-up to elections in Holland. PPG were supported by activist investor, Elliott Advisers, which had acquired a 3% stake, and quickly targeted the Chairman of AkzoNobel as the core hindrance to their plans. They attempted to get the Dutch courts to approve moves to remove the Chairman, but their plans were thwarted when the Dutch business court rejected their claim. PPG shortly after abandoned their pursuit of AkzoNobel without submitting a further offer.

In the three months of courtship/warfare, PPG attempted to get the support of the major investors, raising their putative bid three times, and did indeed gain the expressed backing of a significant proportion of the leading shareholders. Ultimately, however, the fight took its toll and the CEO of AkzoNobel later announced his resignation on ill-health grounds and the chairman said he would retire when his term came to an end next year.

But the importance to PPG of the deal is illustrated by the final (rejected) bid which represented a premium of 50% to AkzoNobel's undisturbed share price. And why were they so driven (desperate?) to conclude the acquisition? The answer must lie in the obsession with the short-term expectations of that stakeholder group represented by the investors. The demand for steady, annual increases in shareholder value, regardless of the practical implications for the other key stakeholders, customers and employees, and regardless of the medium and longer term developments in the company's markets, puts the management team in a dangerous position if they can't maintain their independence.

This is why so many of the big mergers and takeovers destroy shareholder value instead of enhancing it, as promised. The long term sustainability of the business is damaged by short term objectives, pursuing unrealistic goals of never-ending growth in earnings and share prices, through over-paying for acquisitions and over-leveraging to fund them.

So, whereas some of the larger shareholders in AkzoNobel will be ruing the missed opportunity to book a big capital gain, the company itself and its employees are freed to pursue a measured approach to their long-term sustainability, survival and success. Talk of what might have been (for the investors) if the takeover had been successful has to be set against the record of value destruction (and detriment for other stakeholders) which has been shown to be the general consequence of such transactions.

Fifa

The scandals at Fifa are too well-known to need repeating here, but recently the UK's Guardian reported a survey endorsed by Transparency International that of fans surveyed in fifty countries, more than half didn't have confidence in Fifa. Indeed 98% of the 25,000 surveyed said they remained concerned about corruption at Fifa. This despite all the re-organisation since the departure of Sepp Blatter, its much criticised former president.

The current president, Gianni Infantino, former Secretary General of UEFA, was apparently challenged by the Fifa ethics committee during his appointment proceedings over his attitude toward his remuneration and potential conflicts of interest over expenses. Subsequently, following a vote engineered by him, the chairman of the audit and compliance committee resigned.

Most recently, he appears to have prevented the reappointment of the two chairmen of the ethics committee when their terms came to an end, though they had expressed an interest in continuing in office. These two relative neighbours in Europe who both spoke German will be replaced by a Greek and a Columbian, living thousands of miles apart and having no common language.

If one wanted to lift public confidence in the ethics of a very tarnished organisation, surely this is a step one would avoid. It plays to the worst suspicions of those who remain to be convinced that Fifa has turned the page on its bad old habits.

Tracker Funds

In an article last year we wrote about active and passive management and discussed whether the growing popularity of passive funds might be leading to a weakening of stewardship and poorer corporate governance. We considered the notion that in some ways passive managers might exert stronger influence over the governance of investee companies than active managers through their sheer size.

An interesting recent article in the FT by Renaud de Planta drew attention to a different issue deriving from the sheer size of the passive investment industry and growth of tracker funds. He pointed out that the industry was dominated by a few huge groups which effectively constitute an oligopoly, and that there was evidence that investment by these huge investors led in turn to concentration on the leading players in any given industry. This in turn led to oligopolistic structures in the industries concerned and to the consequent detriment of competitive markets in those industries, and he pointed to evidence to support his contention. In the long run, if these trends continued they would ultimately damage the functioning of the market driven capitalist system itself.

As believers in a holistic approach to corporate governance, we would draw attention to the overwhelming bias this trend creates in terms of the dominance of one stakeholder group: the investors. This is clearly bad for customers, if not for the more senior employees of the oligopolies concerned. It also constitutes a big disincentive to invest in innovation and improvements in productivity.

And it lends weight to the urgent need for adoption at a regulatory level of a more balanced assessment of what constitutes good corporate governance. Compliance with codes of behaviour by boards doesn't come within a country mile of being adequate for the purpose.

The last word...

In all the above situations, our holistic approach to good corporate governance stands the test. Applied to each case, the bad consequences would have been avoided or alleviated. In its absence the sometimes catastrophic results have destroyed lives.

ACG is a Trading name of Tangley International Ltd
Tangley House, Tangley Lane, Guildford, Surrey GU3 3JZ United Kingdom

info@applied-corporate-governance.com

Help us deliver what you want

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 enhanced, 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.